CURRENT DEVELOPMENTS
Share Buybacks

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For some years corporate managers in Australia and other countries have observed the use of share buyback powers by companies in the United States with considerable fascination and no doubt some envy. Such powers, they think, add a further dimension of flexibility in implementing corporate strategy, in reacting to change, and in handling circumstances likely to threaten the future of the company or indeed themselves.

Generally, countries with an inheritance of British company law have abided by the ruling laid down by the House of Lords in Trevor v. Whitworth [1886-1890] All ER 46. It was held that a company cannot purchase its own shares or reduce its capital except in accordance with the statutory procedures, or return directly or indirectly the capital subscribed, other than in the course of liquidation or pursuant to statutory authority. The ruling made strong reference to the necessary tradeoffs for limited liability protection for shareholders, and the need to provide protection to creditors through capital maintenance.

Consistent with this ruling the Companies Code prohibits a company acquiring or lending money for the purchase of its shares or those of its holding company (s.129(1)(b)(i) and (ii), s.129(1)(c) and s.36(2)) except under special conditions allowed for elsewhere in the Code. These include the redemption of redeemable preferences shares, reduction of capital, self-purchases by unlimited liability companies and oppression orders.

Now, however, considerable change is apparent. Many countries, including Australia, have reviewed the issue of granting share buyback powers to companies.

In Canada, the Dickinson Report in 1971 recommended companies be given buyback powers, and this was subsequently incorporated into the Canada Business Corporations Act of 1975, and similar legislation was enacted in most provinces. The European Economic Community's Second Directive on Company Law in 1977 permitted companies to re-purchase their shares and this provision has since been incorporated into the company law of member countries, albeit to varying degrees. The British Government found it necessary to consider the issue in some detail, perhaps because of the considerable change the granting of buyback powers would represent to a long established position. A Green Paper was issued in June 1980 entitled "The Purchase by a Company of its Own Shares" that canvassed the issues and recommended the granting of buyback powers to companies.

The recommendations were incorporated into the 1981 Companies Act and later the 1985 Companies Act. Some European countries were less enthusiastic than the British and introduced buyback powers on a restricted basis. West Germany, for instance, has declined to allow public companies (AGs) to purchase their own shares. In Japan, public companies in Japan are not allowed to purchase their own shares and I believe that in New Zealand they have looked at it and at the moment are putting it on hold.

CSLRC Recommendations

In Australia the Ministerial Council for Companies and Securities referred the issue of share buyback powers to the Companies and Securities Law Review Committee (the CSLRC). In June 1986 the Committee issued Discussion Paper No. 5, "A Company's Purchase of its Own Shares", which attempted to canvass the arguments for and against the granting of such powers to companies.

The Australian Associated Stock Exchanges (AASE) also issued a discussion paper in May 1986 which recommended that the Companies Code be amended to permit companies to purchase their own shares. Both papers invited public discussion and comment.

Surprisingly, the response from business and the financial press was rather muted. As one commentator noted, the market greeted the two papers with a yawn of indifference. The papers seemed to generate more interest amongst the regulators and the legal profession rather than the business world. Perhaps the business community was complacent towards the papers because it felt that change was inevitable given the cautious support of the Chairman of the National Companies and Securities Commission for the granting of buyback powers to companies; the relative inactivity of the regulators towards the buyback aspects of the Woolworths-Safeway share transaction in 1985, the BHP-Bell-Elders peace accord, the Amada joint venture share purchase vehicle and the Pioneer arrangement; and the changes to buyback powers that occurred overseas. Or perhaps it was not considered an important issue in the booming share market conditions in the pre-October 1987 period. This attitude, however, was soon to change.

In September 1987, the CSLRC issued its Report to the Ministerial Council. The Report recommended that buybacks be permitted under special conditions. These recommendations represented a compromise between the relatively relaxed buyback conditions prevailing in Canada and the US and the more restrictive conditions in place in Britain. In brief, the Report recommended that:

(i) a company may acquire its own shares through on-market purchases, pari passu offers to all shareholders, or selective buybacks from individual members, provided it is empowered to do so by its memorandum or articles of association;

(ii) directors may acquire 10 percent of a company's shares in any 12-month period without prior shareholder authorization, or more by ordinary resolution, and only undertake selective self-purchases by special resolution of shareholders;

(iii) any power conferred on directors to engage in buybacks in the memorandum and articles of association to be subject to a sunset provision;

(iv) non-dissenting directors to make a declaration of solvency at the beginning of each six-month period over which buyback transactions would occur;

(v) and re-purchased shares must be cancelled.

These recommendations represented a compromise between the relatively relaxed buyback conditions prevailing in Canada, and the more restrictive conditions in place in Britain. Whilst major recommendations (i), (ii) and (v) are similar to provisions in the British legislation, in a number of other respects the British situation is more restrictive than the proposed situation in Australia. For instance, the British legislation stipulates that buybacks can only apply to fully paid shares and must be financed out of distributable profits, the proceeds of a fresh issue of shares made for the purpose of the self purchase or, in the case of private companies, out of capital. The CSLRC recommendations follow the Canadian example in not applying any funding restrictions to buybacks.

On the other hand, the recommendations are more restrictive than the existing British and Canadian legislation in other respects. In Britain, solvency declarations are only required in the case of private companies financing buybacks out of capital. However, not only are assenting directors liable for damages if a company is insolvent within 12 months of a buyback, vendor shareholders may also be liable to the extent of the amount received for their shares. The CSLRC has proposed that assenting directors be liable in the case of insolvency within six months for all buybacks.

In Britain, the London Stock Exchange has imposed additional restrictions on the use of buybacks. For example, listed companies are not permitted to purchase their shares within two months of the release of the annual or half-yearly results.

Also, purchases likely to exceed 15 percent of share capital within a 12 month period must be made by way of a tender or partial offer to all shareholders. Given its support for the CSLRC recommendations and the content of its own report, the AASE is unlikely to propose similar restrictions.

Recent Developments

These recommendations were considered in December 1987 by the Ministerial Council. Prior to this meeting it was clear that the Commonwealth Attorney-General and the Victorian Attorney-General were opposed to the introduction of buyback powers. The Council decided to postpone the decision until a further report has been received from the NCSC canvassing alternative options including share cancellations. In addition it was expected that the Consulting Committee advising Mr Bowen would produce recommendations on the issue and that the Council would have a paper on buybacks from the Commonwealth Attorney-General's Department.

If a company became insolvent, the non-dissenting directors would be personally liable to compensate the company for the total funds expended on self purchases in the six months prior to insolvency. Of course, it will be up to the courts to assess responsibility for insolvency and the extent of liability.

In the meantime, companies appear to have developed a greater interest in buybacks in the aftermath of the October collapse. The need for numerous companies to undertake major corporate restructuring, and a desire to support share prices as a defence against takeovers, generated considerable support for buyback powers in the business community.

There has been some comment that if buyback powers were in place prior to the October crash, the effect of the crash would not have been as severe. I disagree with that because the market was severely overheated, the prices did not reflect the earnings of those companies, and if the company buys back its shares at that price, then it is a very bad investment, and you would have to question the managers.

The Business Council, the Australian Association of Stock Exchanges, and several leading businessmen, all called publicly for the introduction of buyback powers. In addition, two of the country's largest companies have moved to exploit loopholes in the Companies Code in order to engage in buybacks or a version thereof. BHP recently purchased 20 percent of its own capital from Bell Resources, and it is a joint owner of a company created to hold its shares formerly belonging to Elders-IXL. I think this deal has resulted in about a five to six percent reduction in the net assets of BHP because of the increase in debt of about one billion dollars. In effect the immediate beneficiaries of the deal are Bell Resources, Elders-IXL and the BHP management. Certainly not the shareholders or the creditors of the company.

Pioneer Concrete has also purchased six percent of its shares from the Bell Group. In both cases the NCSC did not intervene, although it has examined both moves carefully. Under the Code s.36(5) it is possible for a company to acquire another company which owns its shares, but the shares must be sold or cancelled within 12 months. Unless buyback powers are introduced other companies are likely to follow this course of action. Indeed, it was recently announced that De Laurentiis Entertainment proposed to purchase DEG Holdings Pty Ltd, a wholly-owned subsidiary of the US corporation De Laurentiis Entertainment Group. This subsidiary owns 46.91 percent of the Australian public company.

It is considered that these events have changed the focus of the debate over the buyback powers. Instead of the debate being about whether buybacks should be permitted, it is now concerned with what form they should take.

The CSLRC recommendations were again considered by the Ministerial Council in March of this year. It was decided to allow the introduction of share buybacks, albeit on a restricted basis. All offers to repurchase shares by <u>public</u> companies would be on a <u>pari passu</u> basis to all shareholders. <u>Selective buybacks</u> are <u>not</u> to be permitted for public companies. Furthermore, considerable emphasis was to be placed on the rights of shareholders, creditors and the NCSC, to appeal to the courts concerning a buyback proposal.

The issue has now been passed back to the NCSC for the development of drafting instructions, with an expectation that a draft of the legislation will be considered at the June meeting of the Council. Thereafter the proposed legislation will be available for public comment before proceeding to Parliament for consideration.

This limited approval of share buybacks has been sharply criticised by the Business Council because:

* it falls well short of the recommendations of the original CSLRC report;

* it will delay the introduction of an important reform;

* it fails to take into account the considerable testing that buyback powers have received in Britain, the United States and Canada; and

* it is contrary to advice provided to the Council by the NCSC.

Considerable lobbying can be expected to be exerted to extend the scope of the proposed powers before it is considered by Parliament, possibly later this year.

Should buyback powers be granted to companies and, if so, what should be the extent of such powers?

Generally, the CSLRC Report argued that change is necessary because:

* shortcomings exist in the traditional capital maintenance rationale behind the statutory prohibitions on buybacks;

* the growing ability and inclination of companies to circumvent the prohibition on buybacks in the Companies Code by acquiring an interest in a shareholder, and the difficulty experienced in developing an effective response to this trend;

* the difficulty companies experience in reducing excess capital.

It is argued that these problems are best dealt with by the introduction of buyback powers for all companies.

Private Companies

The case for permitting private companies to engage in share buybacks would appear, on the whole, to be both a different and a stronger case than for public companies. Such an option would:

* overcome the share disposal problem for private companies arising from the retirement, death or loss of interest in the company by shareholders;

* permit the greater use of share incentive schemes for employees; and

* encourage investors to take minority shareholdings in private companies by increasing the marketability and liquidity of such investments.

An adequate supply of equity capital consistent with an objective of maintaining the controlling interest of the founder/owner or descendants, is a major constraint on the growth of private companies. If the introduction of buyback powers improves the flow of equity capital to these companies, it should be supported on economic grounds.

Given the lack of share market valuations, as a yardstick to assess buyback prices in private companies, some additional safeguards to those proposed by the CSLRC may have to be introduced to ensure that the interests of minority shareholders in private companies are protected. As previously discussed, the Ministerial Council has suggested that the legislation emphasize an appeal to the courts by disadvantaged shareholders (and other parties). An alternative may be to allow for expert opinions on buyback prices in certain circumstances.

In the four years after buyback powers were introduced in Britain nearly 1000 companies have repurchased their own shares. The fact that virtually all these have been private companies emphasises the advantage to these companies of access to such powers.

Public Companies

The case for permitting public companies to engage in share buybacks is a more sensitive one than for private companies. The CSLRC Report advanced a number of potential benefits arising from public companies using buyback powers. The major ones include:

* an improvement in the competitiveness of Australian securities in international financial markets, in the sense that Australian companies should have the same control over their equity as British, Canadian and US companies enjoy. Also, a lack of buyback powers may discourage international companies from incorporating in Australia;

* buyback powers could increase mobility of capital in the securities market by chanelling excess liquidity back into the market and increasing the depth of the market;

* when used as a takeover defence buyback powers may create a more competitive price environment and higher returns to shareholders of target companies without necessarily prejudicing the interest of bidding companies;

* share buybacks may discourage uneconomic takeover activity;

* buyback powers may represent a prudent investment by a company when its share price is depressed, reduce overheads by the removal of small holdings, and restore close control to public companies;

* share buybacks would encourage employee share schemes and facilitate financial restructuring.

The CSLRC Report also considered a number of problems arising from the granting of self-purchase powers. These include:

* improper discrimination between shareholders, especially in the case of selective repurchases, with favoured shareholders receiving a substantial premium;

* buybacks may provide opportunities for management to inflate the market price of a company's shares, in direct breach of Part X of the Securities Industry Code;

* buybacks may create additional opportunities for insider trading through knowledge of a repurchase decision, or a company deciding on a buyback on the basis of undisclosed information;

* buybacks may enable existing management to consolidate their control of a company to the overall detriment of the shareholders;

* the granting of buyback powers may provide an opportunity for shareholders with the potential to launch a takeover bid or disrupt the affairs of a company to extract "greenmail" premiums via selective buybacks;

* the funding of a buyback increases risk to the creditors and remaining shareholders in the company.

Further Considerations and Evaluation

After reading two discussion papers and a report on share buybacks which, in total, amount to approximately 250 pages and numerous articles, I feel a little uneasy. It is difficult to determine if the underlying purpose of all those studies is to create, on balance, a convincing case for the introduction of buyback powers for public companies or that other issues were unintentionally neglected. The claimed benefits seem general and superficial when compared with the likely problems, especially given the strong emphasis on the equitable treatment of corporate investors in company legislation in Australia.

Will the introduction of buyback powers make Australian equity securities more competitive in the international markets? No evidence that I have been able to unearth has been presented in support of this proposition or of the related proposition that the lack of buyback powers has discouraged overseas companies from incorporating in Australia. The considerable overseas interest in Australian equities evident in recent years, including the takeover of Australian companies by overseas corporations, illustrates the tenuous nature of these propositions.

It has also been argued that buyback powers will increase the financial flexibility of companies. They will be able to adjust their financial structures more readily to changed circumstances. Again there has been little evidence presented of corporate inconveniences under existing conditions. In fact, the considerable development of the capital markets in this country, particularly in the area of short-dated debt securities, has provided ample scope for companies to adjust the capital structure readily. In other words, the market place has long adjusted to the fact that buyback powers were not available in Australia for financing adjustments by developing other means. Moreover, these alternative means that they are developing, avoid many of the problems arising from buybacks previously discussed.

Another aspect that has not been addressed in any report is the taxation concerns regarding buybacks. To the extent that buybacks deliver capital gains to the shareholders, exposure to capital gains tax will be generated, reducing returns. It may be more attractive for companies to invest excess liquidity on behalf of shareholders, particularly if the returns in the form of dividends can be delivered to the shareholders tax free through dividend imputation.

It should be emphasised again that many countries either do not permit buybacks by public companies or impose more restrictive conditions than that recommended by the CSLRC. Even in the US the situation is not as unrestricted as claimed by commentators. Although the Model Business Corporation Act provides for relatively unrestrained use of buyback powers it has no legal standing. It was developed as a standard for state-based corporate legislation by the corporate section of the American Bar Association. Many States in the US have not accepted the buyback sections of the latest version of the Model Act. Indeed, there is an obvious lack of uniformity in state policies towards share buybacks that is frequently overlooked. For example, while the State of Delaware has a very liberal approach to the issue, California imposes a number of restrictions including the possibility of shareholder-imposed limits on the buyback powers of management; the cancellation of self purchased shares, and complex restrictions concerning the funding of buybacks.

The cautious international approach to buybacks is not surprising given the magnitude and nature of the problems that can, and have, arisen. Can adequate safeguards be established to prevent the abuse of buyback powers? The CSLRC appears to believe that adequate provisions exist within current legislation to cope with most potential abuses. For example, buybacks aimed at rigging market prices would be in breach of Part X of the Securities Industry Code; insider trading could be in breach of s.127 of this Code (although the CSLRC has suggested amending this section to cover buybacks specifically); and the application of common law in s.229 of the Companies Code relating to the fiduciary obligations of directors would prevent them from reinforcing their control of a company at the expense of shareholders. In addition, the need for shareholder approval of selective buybacks as recommended by the CSLRC would control instances of greenmail, whilst the imposition of joint and personal liability on directors would reduce the likelihood of buybacks causing corporate insolvency.

Although these preventive measures are naively well argued in the CSLRC Discussion Paper and Report, there is, nonetheless, some cause for uneasiness as to their effectiveness. The record of regulators in coping with price rigging and insider trading in Australia does not create confidence in their ability to cope with instances of abuse of buyback powers, let alone detect when such abuses have occurred. It is not surprising therefore that the Ministerial Council has embraced the concept of buybacks with substantial caution, and also decided to enhance the role of the courts as the protector of the interests of the vulnerable parties. Furthermore, the Council has decided not to permit selective buybacks for public companies, even on a restricted basis, given the record of greenmail in the US.

Conclusion

Share buybacks have long been prohibited in Australia. If this position is to be reversed, strong evidence of the need for, and desirability of a change should be presented. Whilst such a case has been made for private companies, in my mind it has not yet been established for public companies.

Public companies in Australia have coped adequately without buyback powers, and it has not been shown that their efficiency, or the efficiency of the capital market has been affected and would be improved by the introduction of such powers. What the discussion of this issue has highlighted, however, is that granting of buyback powers would create considerable potential for abuse which may threaten the interest of shareholders and corporate creditors. The British experience has shown that very few public companies have taken up the right to repurchase their shares. Why then, should we persist with an issue that has suspect benefits, considerable potential for abuse which may be difficult to detect and prevent, and may be used by very few public companies?

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