CORPORATIONS LEGISLATION - SHARE BUY BACKS AND SECTION 129

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A great deal has been said and written about why we need new rules on share buybacks. It boils down to this; they are supposed to make our capital markets work more effectively.

The question I want to address in this commentary is whether these new rules will do what they are supposed to do. Will they really grease the wheels of Australian capital markets?

The answer, in my view, is no. Those new rules do present opportunities for creative work by lawyers and accountants in one-off restructuring situations; but in my opinion their overall impact on the working of Australian capital markets will be negligible. I say that for three reasons:

- First, the new rules are just too complex.
- Secondly, there are significant tax problems in using them.
- Thirdly, the risks assumed by directors in deciding to buy back their companies' shares are frightening, to say the least.

COMPLEXITY

What would you get if you crossed the Ten Commandments with the *Income Tax Assessment Act*? Easy : Division 3A of Part IV of the *Companies Code*. In other words, the new plain English rules on share buybacks. The most benevolent thing I can say about the draftsman's 55-page brainchild is that he still has some way to go before he becomes the master of the plain English technique. Someone else described this 55-page book as "Noddy's Tour of the Capital Markets".

So how are we going to understand all this, let alone remember it? The only way I could find was to make up a couple of matrix charts (Appendices 1 and 2). Now people are always giving me matrix charts, and they usually leave me totally confused. If these charts confuse you, I am sorry - throw them away and plough through the 55 pages for yourself.

In the public company area you can see from the chart that the least complex, and therefore the most likely to be used, is the on-market buy-back. Actually, I am being a bit premature in talking about on-market buy-backs; they do not even exist yet. They are not referred to in Division 3A at present. The legislation that brings them in will not take effect until the Australian Stock Exchange (ASX) comes up with new Listing Rules to control the way they operate. The ASX put out one exposure draft earlier this year but that was roundly criticised, so they have gone away to revise it. The latest word is that the new draft is due out in June.

If you do try to read the legislation I have no doubt you will see my point that these rules are too complex to be widely used, with the possible exception of two areas : one-off reconstructions and on-market buy-backs by public companies. Both of these have their own problems.

TAX

In the reconstruction area, a major problem is tax. Mr Keating made an announcement about the tax effect of share buybacks on 31 October 1989. The amendments were picked up in the *Taxation Laws Amendment Bill (No. 3)* 1990 which was supposed to be debated in the Senate yesterday and all being well, to secure Royal assent in June.

The legislation will make buybacks tax-neutral for the *company*, but it will have some important effects on *shareholders*.

In a nutshell, that part of the price which does not come out of nominal capital or share premium reserve has to come out of distributable profit - so the tax-man will treat it as a dividend. The most obvious consequence is for shareholders who have had their shares since before 20 September 1985. If they sold to someone else, they would pay no tax; but if they sell to the company, they pay tax on the "deemed dividend".

Even for shareholders who bought since 20 September 1985, there can be problems : if they sell the shares for less than the purchase price, they don't expect to pay tax. But the tax effect does not depend only on whether they gain or lose on the transaction - if they lose, they will still have to pay tax on the "deemed dividend" component.

The only exception is for an on-market sale. In this situation no part of the price will be treated as a dividend. The principle is that shareholders who sell on-market should not face discrimination depending on whether they sell to the company or someone else.

The effect of this is to increase the complexity of all off-market buybacks and increase the attractiveness of on-market buybacks. But these too have their problems - especially for the directors of the company.

PROBLEMS FOR DIRECTORS

2-Month Warranty of Solvency

Not only must directors declare that the company *is* solvent, but that it will *remain* solvent for 12 months after completion of all planned buybacks - (s 133BH).

If the company does become insolvent during the next 12 months, the directors are personally liable, jointly and severally, for any money the company paid out to buy back shares in the last 12 months - (s 133QC).

What this amounts to is a 12-month warranty of solvency. To complicate the picture even further, and completely demoralise the poor old director, he has a duty to revoke the declaration if he forms the opinion that the company would not remain solvent for the full 12 months. Try and imagine the kind of pressure this would create in a boardroom! And imagine the effect on a company's position if it revokes a solvency declaration : all suppliers would put it on cash terms at once, and the doubts about its solvency would almost certainly become self-fulfilling.

The only kind of company that can sensibly take the risk of making one of these declarations is one that is in an absolutely impregnable financial position.

Securities Industry Code

Let us assume there are companies out there strong enough for the directors to give a 12-month warranty of solvency. Why would they want to do it?

All sorts of reasons have been suggested, including switching from equity funding to debt funding. I think that one is a joke in today's market - everyone I know wants more equity and less debt. I do not know anyone who is actually trying to *raise* their debt-equity ratio. Even the redoubtable Mr Bond seems to have given up on that.

The much more likely reasons for wanting to do a buyback are things like this:

(1) The company wants to get its share price up so it can raise more equity through a rights issue.

(2) The company wants to get its share price up and its cash reserves down as a takeover defence.

(3) The company wants to get its share price up because major shareholders (probably including directors or their associates) are complaining that it is too low - usually because the price is getting down near a level where a top-up clause will be triggered under a major shareholder's own borrowings, secured by a mortgage over the shares.

(4) Directors do not think the share price accurately reflects the asset backing of the shares.

Let us look at these one by one.

(1) Getting the price up ahead of an equity raising

The first problem is s 133NC which provides that you cannot make a rights issue or placement within 3 months after a buyback. So if you are going to play around with the market the effects have to last for at least 3 months.

Secondly, the extent to which you can influence the market is going to be limited by the Listing Rules. We have not seen the second draft of the Rules yet, but the first draft said you could not bid more than 5% above the average of the last sale prices over the last 5 trading days. So you can only apply a fairly gentle upward pressure.

Thirdly, and most importantly, you must run the gauntlet of s 123 of the *Securities Industry Code*, which says it is an offence to engage in 2 or more transactions to raise the price of listed shares, with intent to induce people to buy the shares. That is exactly what you are doing if you try to push the price up to get people to subscribe to a rights issue.

As far as I can ascertain there has never been a successful prosecution under s 123, but that is cold comfort to directors - unless they are desperate they will not want to be the first. The penalties under the *Securities Industry Code* are severe - a maximum of $20,000 or five years or both for individuals, and $50,000 for a company.

(2) Getting the price up and cash reserves down as a takeover defence

Now we all know that if directors do something just to fend off a takeover, they are using their powers for an improper purpose and breaching their duty. So invariably you will find that directors will come up with some other reason for what they did. If their action is challenged it then becomes a question for the court to sort out the proper purpose from the improper purpose. The High Court said in *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285; (1987) 5 ACLC 421 that the test should be a "but for" test.

I will not say any more about that - I will go on to the sorts of reasons directors are likely to give for doing a buyback, whether they are the true reasons or just window-dressing for a takeover defence.

(3) Getting the price up to please shareholders

I am not sure that this is a proper purpose either, especially when it is done to take financial pressure off major shareholders

associated with the directors. All the normal rules of directors' duties still apply.

On top of that, any attempt to push the price up will attract risks associated with s 124 of the *Securities Industry Code*. Section 124 is a bit different from s 123 - it prohibits creating a false impression with respect to the market for, or price of, shares *for any reason*. You do not have to be trying to induce people to buy. There was an important High Court case on this back in 1981 : *North v Marra Developments Ltd* (1981) Australian Securities Law Cases para 76-001. What emerges from this case is that if directors want to do on-market buybacks without breaching s 124 they will have to tell the market before they buy, what they intend to do and why. That is fine - except that once the market knows it is the company that is buying, the chances of any long-term rise in the price are virtually nil. Absent some perceived change in the fundamentals, if the shares do go up at all they will be marked down again as soon as the company pulls out.

(4) **Getting the price up to match asset backing**

This is the most common excuse for share price support, whatever the true reason for the support is. But putting aside cynicism and assuming it is true, directors run into yet another problem. If they are going to buy shares because they think they are worth more than the market thinks they are, they have to make sure that they are not basing that opinion on something the market does not know : in other words, that they are not trading with inside information. That, of course, is a breach of *Securities Industry Code* s 128. The only safe course for directors is to flush out *all* price-sensitive information in an annual report or some other publication before they do an on-market buyback.

So between the 12-month personal guarantee of solvency, directors' duties and the *Securities Industry Code*, you can see that share buybacks are a minefield for directors. Just to make sure no-one gets complacent, the NCSC is warning anyone who asks them about a buyback that the *Securities Industry Code* will be applied vigorously to all buybacks. God knows what their capacity is for enforcing this, but it is enough to put the wind up any honest director. Of course the real desperadoes will take no notice of it.

OTHER ISSUES

There are a number of other interesting points on buybacks. In the time I have left, I can only refer in passing to a few of them:

- Stamp duty : first, it seems that the transfer of shares under a buyback will attract stamp duty on the same terms as any other share transfer - that is at the rate of 0.6% of the greater of the consideration for the buyback or the value of the shares. There is unlikely to be any relief

granted on the basis that the buyback is analogous to a cancellation of the shares.

Secondly, most states have provisions for stamp duty to be paid where a person acquires more than a 50% shareholding in an unlisted corporation within 12 months and the assets of that corporation are at least 80% land. There is a hidden trap here : a shareholder who has acquired slightly less than 50% of the company in the last 12 months will have to ensure that his shareholding does not increase to 50% or more by reason of a buyback of someone else's shares, without any action on his part at all. Otherwise he will have to pay stamp duty at conveyance rates based on the value of the company's real property.

- Stopping a buyback : the objection procedure in Subdivision L is available only to creditors and confined to solvency issues. If anyone else - for example a shareholder - wants to stop a buyback, the way they can do it will apparently depend on whether or not the procedure in Division 3A has been properly followed. If the procedure *has not* been properly followed, the transaction is not protected from the prohibition in s 129 by ss 133CA and 133CC - because the conditions prescribed by Division 3A have not been satisfied. It follows that the acquisition would be a breach of the Code (ie. of s 129), and could be restrained in advance (or possibly ratified after the event) under s 574. Section 130, it seems, will not allow the buyback to be avoided, because of s 130(1)(ba) - because the "buybacks" protected by s 130(1)(ba) are defined by reference to s 133BC, and include purported buybacks which do not comply with the rules.

  Where the Division 3A procedure *has* been followed, a challenge to a buyback is more likely to be brought under s 320 (conduct which is oppressive or not in the interests of the majority), or s 229 (breach of directors' duty) combined with s 574.

- Experts' reports, required under s 133KE for a selective buyback by a public company : should the issue on which the expert has to express an opinion be whether the *transaction as a whole* is fair and reasonable from the viewpoint of other shareholders, rather than simply whether the *consideration* provided for the buyback is fair and reasonable?

I said at the beginning that the policy behind these amendments was to make capital markets work better. I am not so sure if that is right. I am slowly beginning to realise that it may be part of a grand government strategy to transfer wealth from the industrial and commercial sectors of the economy to the services sector. This is what some people call a lawyer-led recovery.

There is only one flaw in this policy of otherwise Machiavellian cunning - the new rules just might be too complicated and dangerous for anyone to use.

As a director, I cannot see myself rushing into any share buybacks. As a lawyer, I hope I am wrong - I hope other directors will be prepared to live dangerously. I hope share buybacks are used abundantly - by others - because they will be a bonanza for lawyers.

Who cares about the productivity of industry? Who cares about giving directors clear rules to apply in making their decisions? Why should they sleep soundly at night? [What have I done with those letters of resignation?]

Long live the lawyer-led recovery!

APPENDIX 1

PUBLIC COMPANY BUY-BACKS

	Conditions to be satisfied					
Type of Buy-Back	AUTHORISATION IN ARTICLES (Note limited life - s 133DB)	AUDITED SOLVENCY DECLARATION	10/12 LIMIT	SHAREHOLDER APPROVAL	CREDITORS' OBJECTION PROCEDURE	EXPERT REPORT ("Fair & Reasonable")
BUY-BACK SCHEME (Proportional offer to all shareholders, like Part A takeover)	Yes s 133DA	Yes s 133MA	Yes s 133EA	Only if takeover - pending s 133GA	Yes s 133LA	-
ON-MARKET PURCHASE	Yes s 133DA	Yes s 133MB	Yes s 133EA	-	-	-
SELECTIVE BUY-BACK (Special deal with one or more shareholders)	Yes s 133DA	Yes s 133MB	Yes s 133EA	Yes - special 75/75 majority s 133JA	Yes s 133LA	Yes s 133KE
EMPLOYEE - SHARES PURCHASE	Yes s 133DA	Yes s 133MB	Yes, unless shareholders approve s 133HA	Only if 10/12 limit exceeded s 133HA	-	-
ODD - LOT PURCHASE	Yes s 133DA	Yes s 133MB	-	-	-	-

APPENDIX 2

PROPRIETARY COMPANY BUY-BACKS

	Conditions to be satisfied				
Type of Buy-Back	AUTHORISATION IN ARTICLES	SOLVENCY DECLARATION	AUDITED SOLVENCY DECLARATION	SHAREHOLDER APPROVAL	CREDITORS' OBJECTION PROCEDURE
BUY-BACK SCHEME (Proportional offer to all shareholders, like Part A takeover)	Yes s 133DA	Yes s 133MA	If the buy-back exceeds the 10/12 limit s 133MA	Ordinary resolution required if: - the 10/12 limit is exceeded; or - a takeover is pending or remains open s 133GA	Yes s 133LA
SELECTIVE BUY-BACK	Yes s 133DA	Yes s 133MB	If the buy-back exceeds the 10/12 limit s 133MB	Special 75/75 majority if the 10/12 limit is exceeded s 133JB	Yes s 133LA
EMPLOYEE SHARE PURCHASES	Yes s 133DA	Yes s 133MB	If the buy-back exceeds the 10/12 limit s 133MB	Ordinary resolution required if the 10/12 limit is exceeded s 133HA	-