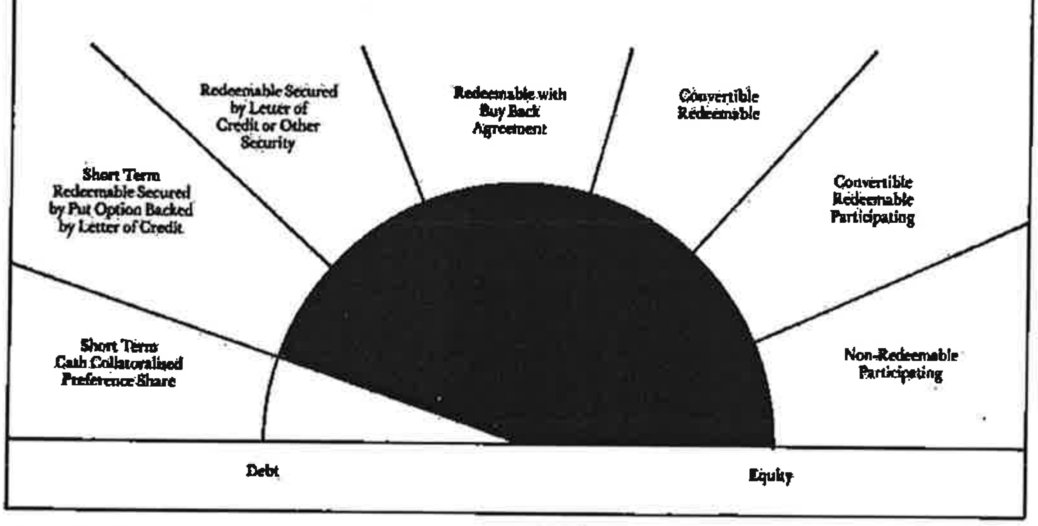
Preference Share Issues and Financing

Comment: M. Perry

I guess I am slightly unlucky compared to S.E.K. Hulme: I tried to find a definition of Preference Shares in Twelfth Night or Othello, and I found both sadly lacking. I thought my starting point would be, therefore, to ask the question 'are preference shares debt?' I think I can answer that question categorically and without fear of contradiction by saying yes, they are, and no, they're not.

I think with such a simplistic question you have got to look far more closely at what preference shares are and the variations on a theme. You have also got to look at who is asking the question. The way I would like to consider this is by looking at the first diagram (see diagram 1).

Diagram 1: Preference shares — debt or equity?



I have taken two extremes. On the left hand side is an extreme which I would say is demonstrably a debt type of instrument; on the right hand side, something which I believe is demonstrably an equity type of instrument. The sequence of instruments on this diagram go from cash collateralised preference shares moving on to short term redeemable secured, option backed, letter of credit preference shares; a redeemable secured by letter of credit or other security preference shares; moving along to a redeemable with a buy back arrangement preference share; a convertible (presumably into ordinary equity) redeemable preference share and coming down to convertible redeemable participating in some profits preference share and ending up in a non-redeemable participating preference share. In a simplistic form, this diagram shows that when we talk about preference shares there are many variations on a theme.

On the left and the right extremes, I think the answer to the question of debt or equity is fairly straightforward. On the left hand side, the investors there are taking virtually no credit risk, their return is defined and secured, they share in no super profit and in a credit sense, they are in a superior position to unsecured lenders. On the extreme right hand side, the investor is looking at something very different. He is looking at investing permanent equity, which is not secured; he is at risk and will share in super profits of the business. In between there are areas of grey.

I think there are probably five basic questions in determining what is a preference share in terms or debt or equity. Very briefly, I categorise these as follows:

1. Is there a redemption or buy back arrangement or is it basically permanent equity?

2. What is the term; is it a short, medium or long term and is there thus an impact for other creditors?

3. Is there any security supporting the issue, if so, is it external to the issuer, such as a letter of credit or is it internal, such as a mortgage?

4. What are the voting rights; do the holders of those shares have a true say in the running of the business, or are these voting rights limited or virtually non-existent?

5. What is the nature of the risk/return; is the return fixed by some pre-arranged formula or does the holder share in the underlying profitability of the business?

The view is also in the eye of the beholder in terms of a preference share. We have got a lot of different people looking at preference shares; auditors, legislators, bankers. It is interesting to note that the Reserve Bank for example considers all preference shares as equity in terms of looking at the portfolios of Official Dealers. I am sure that bankers, academics, auditors and others could take a diametrically opposing view.

I would just like to close by saying that if there is some action by lawyers or legislators to change the status of preference shares in terms of reporting and taxation, I would hope that they would not impact on the right hand side of the graph because I believe there is a legitimate role for preference shares in that area.

Comment: G. Sawyer

There are really two aspects of the debt or equity question that I would like to discuss very briefly this afternoon. The first is to deal with accounts presentation and the question of true or fair view. The second question that I would like briefly to mention, is the one that I suppose, is on everybody's lips and that is the question of when, or if, the tax authorities are going to move and what is the attitude of the tax authorities to the question as to whether preference shares are debt or equity.

Dealing with the first question on accounts presentation I am sure you are all aware there has been some recent publicity. One of the major auditing firms around town has made statements that in their opinion a number of the preference issues around are truly in the nature of debt and the presentation of accounts which shows those shares as equity rather than debt, is not giving a true and fair view of the accounts.

Now, if you look at all sets of accounts at the moment, the current practice is indeed to treat preference shares as capital rather than as debt, and that has two substantial effects on the accounts of the companies. First of all, the preference dividend is treated as an appropriation of profits rather than as a charge against profits, so that the profit of the company is shown before the preference dividend, so the operating profits are inflated by this form of financing. The second issue is that it removes from debt in the balance sheet that form of financing, so that if you look at a consolidated balance sheet, particularly if you are dealing with preference shares issued through subsidiaries, then you are not going to pick up the correct debt figures because the debt is hidden in the item minority interests which I think the great majority of readers of financial statements have a little bit of difficulty understanding.

It is perhaps easier to understand the issue by looking at an actual example and what is on the board there at the moment is the position of Adelaide Steamship (see below), who are probably one of the more well known issuers of preference shares and to be fair it is one of the best sets of accounts around.

Example:	*Current practice*	*Alternative*
Operating profit	$34.4M	$21.8M
Excess of current assets over current liabilities	$54.3M	$32.7M
Debt equity ratio	5:6	6:5
Percentage of debt to total assets	39%	53%

You will see there first of all on the operating profit line that the treatment of dividends as an appropriation of profits rather than as a charge against profits has an effect on the profits of some 12 million dollars. If you were reading the accounts the only way you would really pick that up is (1) through the fact that there is below the operating profit line a very large elimination from the minority interest in relation to companies which are virtually all wholly owned and (2) you can pick it up through the statement of the sources and application of funds.

The next effect that it has, is a very substantial effect upon the gearing of the company. The group has something in the order of 86 million dollars worth of redeemable preferences. I say something in the order, because you can't quite tell from the accounts. In addition, there is a further 50 odd million in associated companies which are not included on the balance sheet. The group has in total 134 million worth of preferences. The only way you know that is through a gratuitous statement in the accounts. It is not required to be disclosed and again it is an example of the good presentation in those accounts, that it is. But as you can see, in relation to current assets and liabilities, it makes a big difference to their excess of current assets and a big difference to the gearing ratios.

I think all that proves is that it can be misleading to treat preference share capital as debt. The interesting thing in the debate to date is that there really is no basis in the Companies Code for saying that you can't treat preference capital as a charge against profits in relation to the dividends, and as debt in the balance sheet. The only thing stopping their change in treatment is conventional wisdom. There is nothing in the Companies Code which precludes showing the preference capital somewhere else on the balance sheet, a lot closer to debt.

The second issue, and one of major interest is the attitude of the tax department. Largely I think it is a political issue and so it is more important to listen to what Mr. Keating might have to say than it is to what the tax department says.

To date there is no official statement of attitude from Mr. Keating or the tax department. I understand there have been some unofficial remarks passed, but I couldn't track those down and in fact we have spoken to Mr. Keating's office and there has been no official statement made at all.

The problem with preference shares I think is they're heading in the direction of leverage leases and that is that the original idea was fine, but as time passes the ideas get 'cuter' and 'cuter' and as a result we are getting closer and closer to the stage where eventually the tax commission has got to call a halt. And by that I mean that we are now looking at issues from tax exempt companies such as gold miners and we are looking at things like the possibility of various public instrumentalities making issues. If those things happen, then clearly what you have got is not just a deferral of tax but a complete avoidance of tax, and if that happens then I think it is inevitable that we are going to get a change in the law.

Beyond that I don't think you can really say anything sensible about what may or may not happen in the future. I think we are all right so long as things don't go too far. Inevitably they will go too far, therefore we are going to get a change in the law sooner or later.

Comment: P. Weaving

When Redeemable Preference Shares (R.P.S.) financing first emerged several years ago, as a trading bank we had to make a decision as to whether R.P.S. finance was debt or equity. As you are aware the Reserve Bank subjects all the trading banks to certain regulations.

One of these regulations is the level of investment one can have in the company, for example for a merchant bank, the level of investment at the moment is 60%. At the time of R.P.S. finance several years ago it was 30%.

Another regulation concerns the type of company a trading bank can invest in. Very broadly a trading bank can only invest in a company where that is relevant to finance. The Reserve Bank several years ago informed banks that they regarded these transactions more in the nature of a lending proposal and not an investment. So at this particular stage there are no restrictions imposed by the Reserve Bank. This approach reinforces the concept that R.P.S. financing is debt. If it is regarded as equity then of course under the Reserve Bank regulations the trading banks may not be able to invest in such issues.

In assessing the credit appraisal, a bank or a subscriber cannot rely on existing securities of the company group for payment of moneys in respect of R.P.S. financing. Section 129 of the Companies Code prohibits companies from providing security in connection with the purchase of their shares or the shares of a holding company. Also, in assessing credit, emphasis is given to the treatment of R.P.S. finance in the balance sheet.

In certain situations R.P.S. is treated as capital when in fact it should be classified as either a long or a short term liability. In consequence when we look at R.P.S. financing, two sets of ratios are produced, recasting R.P.S. as a long or a short term liability in lieu of shareholders funds. Also, if the company group is subject to a trust deed, then we also look at the situation whereby the R.P.S. liability could be taken in as debt. In the relevant documentation, provision is made for pre-payment in the event of changes to the *Income Tax Assessment Act*.

We also monitor, as in cases like Adsteam, to ensure that maturity of preference shares are well spread. If R.P.S. was eliminated for one reason or another then the additional cost of such finance could impact adversely on the bottom line.

Comment: G. Robinson

I think the inherent tension in redeemable preference shares has been highlighted by the previous speakers, especially Michael Perry who looked at them from the point of view of the investor. It is clear that from the financier's point of view and also from the issuing company's point of view, that what is being provided is either short or medium term financial accommodation. This I think is particularly highlighted by the fact that, as Peter Weaving has said, the financier will appraise the risk, not as he would an investment risk but as he would the risk of making a loan. The company, on the other hand, is looking for the same flexibility that it would generally obtain with a loan, such as, for example, a right to prepay and the right to have its cost of funds varied over differing interest periods. However, the whole rationale for redeemable preference share funding is that it must be tax effective, that is the investor must be sure of obtaining his rebate on the dividends received. This means that notwithstanding the commercial objectives of both the issuing company and the financier the shares must in law be equity rather than debt. This objective on the face of it will always be achieved where the parties are properly advised because the transaction will take the usual form of an issue of shares pursuant to the company's articles of association. However, when one couples the commercial objectives of both parties with some of the more innovative features of recent issues, I think Greg referred to them as 'cute' which is probably a reasonable way of describing them, the question, in my view, must arise: are the issues, notwithstanding their form, in substance the issue of debt instruments rather than the issue of equity. That question of course is relevant not only in determining the tax effectiveness and accounting treatment of preference share issues but also in determining the nature of the instrument for the purposes of trust deed ratios and other borrowing covenants. Some of the recent innovative features have been directed at making shares as much like money market instruments as possible. Thus, we see shares which are purportedly issues at discount, that is they are issued with a fixed dividend payable in advance, and there is an adjustment made at the time of issue to the premium so that in effect, as far as the investor is concerned, he is getting a discounted instrument. In addition, we see the development of revolving preference share issues — this means that they are issued on a short term basis and when they are redeemed fresh short term shares are issued in much the same way that fresh bills of exchange are issued under a bill acceptance and discounting facility on roll over dates. Finally and perhaps the most compromising of the 'cute' innovations has been to make the instruments more marketable and more readily acceptable in the money market by calling them rebateable notes. Somebody asked me the question over lunch, is a preference share really equity, and I said, well a preference share is a preference share unless perhaps it is a rebateable note, and the reason for that comment of course, is that a note is most widely recognised as a debt instrument rather than as an equity instrument. Now, these features, of course, have developed in response to market requirements. The flexibility inherent in these developments is commendable from the point of view of both the issuing company and from the point of view of the financial institutions that invest in them. However, in some instances, I believe the legal adviser must address the question whether the shares are, in substance, debt instruments rather than equity. The following quote was in a recent case of *Clyne v. Federal Commissioner of Taxation* 83 ATC 4508 where Mr. Justice Yeldham at 4515 cited with approval the statement of Windeyer J in *Scott v. Federal Commissioner of Taxation* (No. 2) (1966) 40 ALJR 265,279:

> A disguise is a real thing; it may be an elaborate and carefully prepared thing; but it is nevertheless a disguise. The difficult and debateable and philosophic questions of meaning and relationship of reality, substance and form are for the purposes of our law generally resolved by asking did the parties who entered into the ostensible transaction mean it to be in truth their transaction, or did they mean it to be and in fact use it as, merely a disguise, a facade, a sham, a false front ..... concealing their real transaction.

In the context of redeemable preference shares which display some of the more innovative features the question for the legal adviser is, did the parties intend to make a loan but adopt a false front so that the lender could receive a rebate in respect of dividend payments.

I make no attempt this afternoon to answer that question, because it will vary from issue to issue, but I do identify this as a risk which is increased with issues which have some of these recent more innovative characteristics.

Comment — Structuring preference share issues: R.J. Nettleton

Sections 129 and 130 of the Companies Code can cause problems both to subscribers for preference shares and to the bank that provides the letter of credit in support of the parent company's agreement to purchase the shares from the subscriber should default occur. Market practice normally requires the parent's obligation to be supported by a letter of credit and the bank providing the letter of credit often also requires an indemnity or other security from the company issuing the shares. The question which then arises is whether the giving of this indemnity or other security to the letter of credit (L.C.) bank constitutes a breach of section 129, which of course prohibits a company financing dealings in its own shares. My view is that it does.

Steps must then be taken under section 129(10) for the company to authorise the giving of the financial assistance. This section permits a company by special resolution to resolve to give the financial assistance; if it is a subsidiary of a listed corporation or has an ultimate Australian holding company, the financial assistance must also be approved by the listed or ultimate holding company. If such authorisation is not obtained, section 130 of the code sets out the consequences. These are essentially that the contract or transaction made in contravention of section 129 is voidable at the option of the company giving the indemnity or the security to the L.C. bank. A member of the company and certain other parties may also apply in the name of the company to the court to have the contract or transaction avoided under section 133.

So the L.C. bank, and perhaps the subscriber because of the related contract provisions in section 130, may find that the security or indemnity is avoided and possibly that the subscription for shares may be avoided. If there are no shares subscribed, the subscriber may also have nothing to put to the parent under the purchase agreement.

Similar points may apply in respect of contraventions of section 128 on the basis that the shares aren't properly allotted. To attempt to overcome this problem certificates are normally obtained under section 130(6) from appropriate officers of the company, that is two directors or a director and a secretary. The certificate is to the effect that the requirements of section 129(10) have been complied with. If this certificate is obtained, it protects the relevant company from having the contracts or transactions in question avoided. However, section 130(6) doesn't help if the L.C. bank or the subscriber becomes aware before the relevant contract is made or transactions engaged in that the requirements of section 129(10) have not been complied with, notwithstanding that it had received a certificate. Section 130(7) gives a wide right both to the company and any other person who has suffered or is likely to suffer loss or damage as a result of the making or performance of the contract or the engaging of the transaction or any related contract or transaction contravening section 129.

A further issue arises where the subscriber has knowledge of a breach of section 129 and he proceeds, regardless, on the basis that he has an irrevocable letter of credit. The question then is whether he would in those circumstances be prevented from claiming under the letter of credit. This could be on the basis that there is a fraudulent transaction affecting the credit or some other circumstances arising out of the contravention of section 129. A court might regard this as entitling it to exercise its discretion to grant an application for an injunction by the company or another interested person to restrain the subscribers from drawing under their letter of credit.

This is a problem. The cases on fraud and letters of credit usually concern trade credits and fraud to the knowledge of the L.C. bank by the seller vitiating the credit so ultimately the buyer doesn't have to pay the L.C. bank.

In the case of redeemable preference shares, if there is fraud or other circumstances vitiating the credit, it wouldn't be in the circumstances found in the cases on trade credits. However, even though courts are reluctant to interfere with payments under letters of credit, subscribers who are aware of a possible breach of section 129 would be well advised not to assume that they would in any event be entitled to claim under their letter of credit.

There must also be considered whether the L.C. bank, if aware of the breach of section 129 before issuing the credit even though the subscriber wasn't aware, might have to pay out on the credit but not be able to enforce its indemnity against the company; or rather it could be faced with the indemnity being set aside. The position is even more obvious if the L.C. bank as well as the subscriber were aware of the breach of section 129.

I turn now to section 128 of the code. That section essentially says that a company cannot allot or convert issued shares into preference shares unless there are set out in the memorandum or articles of the company the rights of the holders of those shares with respect to certain specified matters. It is obviously inconvenient where a company is making frequent issues of preference shares for the articles to be altered on each occasion. The practice is now therefore developing for articles to be adopted which provide that preference shares may be issued by a company the detailed terms of which are contained in a resolution of directors. This permits flexibility with regard to issues of preference shares by a company. The necessary changes in interest rates and dates of redemption of new issues can thus be effected by directors' resolutions. It also avoids the company's articles being cluttered with detailed provisions which become obsolete after the issue has been redeemed.

There is some concern by subscribers that this approach doesn't comply with section 128 and so doesn't provide protection to subscribers on the basis that directors could amend the relevant resolution and thereby change the rights of the subscribers in relation to the shares.

I take the view that once shares are issued pursuant to the articles and the particular resolution of directors there is a contract between the company and the subscribers on the terms set out in the articles incorporating the resolution by reference. And that contract cannot be unilaterally changed by the directors in respect of the matters set out in the resolution.

Another protection would be for the article to permit the terms of an issue to be specified only in a resolution of the directors prior to the actual issue, which resolution isn't subject to amendment. I recognise that there is another view which requires the incorporation of all the detailed provisions in the articles.

A similar argument would apply to section 123(a) of the code, where in setting out the preconditions for redemption of preference shares, this section requires that the shares shall not be redeemed except as provided in the articles. Again I recognise that the market has taken a contrary view on occasions.

Comment — The accounting and tax point of view: G. Sawyer

I suppose one of the benefits of changing backwards and forwards so fast is that we haven't heard any jokes yet. It is getting a bit dry I think. No, we are under specific instructions today from John, no jokes! Particularly no Irish jokes!

I am now about to talk about a subject which should interest all of you, which of course is income tax, a subject of interest to a lot of people. In relation to structuring what I wish to talk about is specifically the tax issues that affect the structure of the issue that you make.

Now, it is fairly obvious that the types of circumstances in which it is beneficial to consider the issue of preference shares for tax reasons, as opposed to other reasons such as dressing up your balance sheet, are, first the company that is in a tax loss position and projects itself being in a tax loss position for some time; secondly, the company that is in the start up phase of its operations, typically say, a mining operation that is about to commence or hotel construction, or something of that nature where there is a major project which is about to commence and which will take some time to reach the stage where there is some income being produced; and thirdly, and what we have spoken about before, is the possibility of companies who have tax exempt income and therefore no use for deductions making issues of preference shares.

Now, what are the issues that you have got to watch when you make the issue? The first one is that the issue of the shares themselves, if made by a company in a tax loss position, can result in the company failing to comply with the provisions of section 80(A) which is the continuing ownership test. The issue of the shares can well result in a situation where you are forced to rely upon the same business test. Now, in most circumstances that is a fairly easy problem to avoid because what you simply do is make the issue out of a company which has no tax losses. For example, an otherwise dormant subsidiary would do the trick and if the shares are issued out of that company and the funds lent across interest free to the operating company, then you avoid the problem. That's not always possible though because one of the things you do need in the company that is going to make the issue is a pool of profits from which to pay the dividends. If the only company you have that has accumulated profits with which to pay the dividends is the company with tax losses, then you have to do just a little bit more careful thinking as to how you are going to go about the issue.

The second tax problem in relation to the structuring of the issue is that until recently most issues have been for a term of, say, three to five years. Now, one of the problems with that is that it is quite possible in some circumstances to have a sudden turn around in results and become profitable sooner than was otherwise expected. The problem with preference shares is that they are very expensive if in fact you get into a tax paying position and you are paying preference dividends with no deductions. The price of preference shares is substantially higher than alternate forms of finance assuming that you could get a tax deduction. So that one of the problems when you are structuring them is to make sure that there is some way to get out of the situation if that applies. Now, of course the two ways to do that are, first, to provide in the issue an option to redeem, either at specified dates or at some sort of notice period, or, alternatively, to go into the newer forms of issue which are the short term issues of between 30 and 180 days. Both of these means give you the flexibility to bail out. In relation to the short term preferences there are a number of advantages and disadvantages of these new types of preference shares.

Obviously the advantage is flexibility, in that you can go in and out of the preference shares very easily and over a very short period, and secondly the other major advantage is cost, because they are priced below longer term preference shares. They overcome the problem of having to have the option there to redeem because the things just go for 90 days, and at the end of that you are out of them and can go into an alternate form of finance.

The disadvantages in relation to those types of shares are first of all, if the issue of shares is a disqualifying event in terms of section 80(A), then you may find that every roll of the shares is in fact another disqualifying event. And so, if you have structured in such a way that that is a problem, then you keep compounding the problem by the issue of these shares. That is particularly relevant where you are going to issue them in a company in the start up phase which otherwise hasn't got tax losses and you are quite hopeful that it won't have any. If you issue in the main operating company there and it does have some tax losses then you can suddenly find yourself in a situation every time you roll the shares that you fail 80(A) and you have to rely on the same business test which can be quite restricting.

The second problem is that, it is problematic but it is probably more likely that those types of shares will be challenged by the tax authorities at some stage. Certainly if you look overseas in the United States for example, those types of preference shares would be looked at on a substance basis and be held to be debt. And we may end up with that approach in Australia at some stage. Related with that is the problem that if you do go into 90 day shares and there is a new issue each 90 days, and you are trying to second guess what may or may not be the way amending legislation would be effected, one possibility is that if new legislation comes in it would only apply to issues after the date of the announcement. Now, the problem you have if you have short term preferences is that automatically you are going to be caught up, because very soon after the announcement you would have another roll over. If on the other hand you have got a three or five year share, then it may be that you have got another three years or so before the law affects you. So that if you are looking at making an issue, particularly in the current climate where there is a lot of speculation about changes in the law, it may well be worth your while to go the dearer route, the three or five years, rather than the shorter route, just because of that possible means of changing the tax law.

The last very quick thing I would like to mention to you is that one of the situations where you have real problems in structuring an issue is in relation to the project just starting up that in fact has no pool of profits from which to pay the dividends. Now, short of actually going out and buying a company with accumulated profits, you have got to think of ways in which you can create profits from which to pay the dividends. If you create true profits the problem that you have got there is that you may well have made a profit which is subject to tax and defeats the whole purpose of the arrangement. So the two things that I leave you to think about are, first of all, the asset revaluation reserve. And I think it is fairly common if you look around you will find companies that are paying cash preference dividends out of asset revaluation reserves. And the second possibility, is the possibility of instead of paying a dividend, paying a further premium on redemption, the source of which would be share premium raised on subsequent issues. In theory at least there is nothing stopping you from having a continuing roll of shares under which you are raising an ever increasing amount of share premium which is used to pay a super premium on the return of the original shares which, depending upon how you read the definition of dividend, should be a rebateable dividend under the tax Act. It should get you out of the problem.

Comment — a merchant banker's perspective: M. Perry

I think today we have been concentrating on the left hand side of the graph that we put up, that is on the debt type instruments. As merchant banks, we have been one of the beneficiaries of those instruments and I think this concentration is a rather nasty turn of events! I would like, therefore, to broaden the discussion somewhat, if I may, by taking the view of an adviser to a firm that is looking to raise finance by way of preference shares. There are two aspects that one would normally look at. The first is the objectives of the issuer and secondly its negotiating position. In terms of objectives, a great deal can be achieved through preference shares. They are an extremely flexible instrument as many of you would be aware. Cheaper finance is but one benefit. Running through the list, cheaper finance in an N.P.V. sense is certainly a benefit, (issues by Phillips Industries are probably an example of that motivation). Secondly, it can improve the balance sheet ratio in a real sense, and I think the recent issue by Pioneer Concrete was probably a good example. Thirdly, it can be an effective form of venture capital finance and I would expect that we would be seeing more of this where external capital is injected into a small company, so that the original entrepreneur's control is maintained through ordinary capital. Fourthly, F.I.R.B. requirements can be accommodated, for example, the Macquarie Bank approach. Fifthly, deferred acquisition finance such as Consolidated Press' issue is another way in which preference shares can be used.

A sixth consideration is the availability of security. We have talked a lot about securing preference shares through internal or external means, but the issuer may be constrained by a trust deed or in fact may not have any security, but it still may be logical to do a preference share issue. Seventh is the control and voting aspects. As an adviser, one has to consider the implications of issuing preference shares which may ultimately change the control of the company either through exchange of those shares to ordinary shares or simply through the voting aspects of those preference shares.

The next aspect I mentioned was the negotiating position of the issuer. What sort of position is he in and what sort of a deal can he negotiate? We have and will touch on aspects such as indemnities and what can be negotiated, and in diagram 2 I have tried fairly simplistically to set out the parameters in which most issuers might find themselves. An issuer on the left hand side finds itself in a very strong position as to the terms it can negotiate where it is issuing shares which offer an upside profit potential and conversion options and in which there is an attractive tenor, pricing and amount in terms of the prevailing market; an early payment of dividends (we have seen, for example, issues now coming on at a discount where the dividend is paid up front); a strong underlying credit; a good financial relationship in collateral business with potential investors and an underlying strong market for such securities. The other side, the relatively weak negotiating position, is to a large extent the reverse of the relatively strong position as shown on diagram 2.

Diagram 2: Structure of issue
Negotiating strength of issuer on terms

Relatively strong	*Relatively weak*
• Upside profit potential/ conversion options	• Set basis of return (fixed or floating)
• Attractive tenor, pricing and amount	• Unattractive tenor, pricing and amount
• Early payment of dividends	• Deferred payment of dividends
• Strong underlying credit	• Weak underlying credit
• Good financial relationships/ collateral business	• Weak financial relationships
• Strong market	• Weak market
• Limited redemption options for issuer	• Redemption options in issues favour issuer

I think I would simply close here by saying that where we have concentrated on the debt type instrument, there are many other forms and the instrument that is ultimately chosen will depend on the objectives of the issuer, the environment in which the issuer finds itself and its negotiating position.

INDEMNITIES

Comment: G. Robinson

I am pleased to be able to say that on this topic I am with the bears rather than with the bulls. In addition to the tax indemnities that the other members of the panel are going to address in a moment, the nature of the parent company support has traditionally been in the form of a "put" option, in other words, on the occurrence of certain events, the parent company or some other company in the group agrees to purchase the shares from the subscribers. The reasons for this are well known and essentially revolve around the probability that a guarantee, which is the alternative, may not be effective if the reason for the default is, for example, the inability of the company to pay a dividend because it doesn't have sufficient profit, or the inability of the company to redeem the shares because it cannot do so in accordance with the Companies Code. However, there has been a recent variation to this particular theme. The variation is that instead of agreeing to purchase the shares from a subscriber, the parent company agrees to subscribe shares itself in the capital of the issuing company sufficient to ensure that the issuing company can redeem the shares on their maturity. A letter of credit is issued in support of this obligation but in some circumstances a trustee intermediates so that the proceeds of the letter of credit can be intercepted by the trustee and paid direct to the shareholders in the event that the letter of credit is called. Obviously, in those circumstances where the letter of credit is called, the shareholders will be assured of getting paid. However, a problem arises where the parent company in fact subscribes for sufficient shares to enable the outstanding shares to be redeemed, but in between the date of subscribing for the shares and the date of redemption a liquidator is appointed. In those circumstances the proceeds of the issue to the parent company would have to be applied by the liquidator and satisfaction of the company's debts before they could be applied in satisfaction of the claims of the redeemable preference shareholders. Accordingly, I find it surprising that that particular approach seems to have found some market acceptance.

Comment: G. Sawyer

As I am sure you are all aware there is virtually always an indemnity in relation to the tax rate, equally, there will always be an indemnity in relation to the continued operation of section 46, whether or not that section is defeated by a change in legislation, a court decision, or a change in policy of either the government or the commissioner. Equally, there should always be an indemnity covering the position where a put option is exercised and the subscriber receives, instead of dividends, an equivalent amount as proceeds from the sale of his shares. Clearly those proceeds are not rebateable. Clearly, he is also going to be taxable on the proceeds because there was an option in existence at the time of the issue and any profit realised is taxable under section 26 (AAA). The three that I wish to talk about are the return of share premium, section 50 and retrospectivity. You may all recall in the battle for Grace Brothers, one of the things that happened was that Mr. Bond made an offer that involved the issue of redeemable preference shares, and the argument then arose as to whether or not the premium subscribed, when it was returned, would in fact be a dividend. It was relevant in that case because most of the holders or some of the holders could have been individuals who would not have been entitled to a rebate and who would have been taxable on that dividend. Now, it requires a reading of the definition of dividend in section 6 and subsections 4 and 5 of section 6, but there is no doubt that there is a possibility that the Commissioner could rule that the amount returned as share premium is in fact a dividend as defined. To date the Commissioner has ruled on a number of occasions that he does not regard that payment to be a dividend. Nevertheless, if you are going to get indemnities that is one that should be considered.

I understand people are now trying to get around the problem by an alternate means which is that, if section 46 is amended to remove dividend rebates, then they would put the shares, and instead of receiving a return of the share premium they would get sales proceeds on shares. In this case they would only be taxable on the profit on the sale of the shares, which would give them an effective deduction for the premium initially subscribed against the premium paid back as sales proceeds, no profit, no tax.

The next indemnity, section 50, is one where obviously it depends upon which side of the coin you are on as to whether that indemnity should exist. It is not a common indemnity and it is one from the issuer's point of view that should always be avoided.

What that is all about is that the subscriber is in fact entitled to a rebate on his net dividend income included in taxable income. And the problem always exists that in determining net income the law provides that you will offset expenses incurred directly in obtaining that dividend income and there is always a potential problem, particularly in the case of the merchant banks that go out and fund these things with bill lines, that the subscriber's interest expense will be offset against the dividends received. In practice, it doesn't happen and the reason for that is that over the years the Commissioner has attempted to win a few cases dealing with net dividend income and has consistently lost and the Courts have held a very literal interpretation of what are expenses directly incurred in deriving dividend income.

The thing about section 50 is that it is really out of the hands of the issuer, it's a matter affecting the subscriber. If the subscriber uses funds which are not borrowed funds then there is no problem with section 50. Given that you have already got an indemnity against change in policy, and change in interpretation and court cases relating to the operation of section 46, there should be no need also to give an indemnity in relation to section 50, because all the matters which relate to the risk of the issuer are covered in those indemnities. Anything further is really an issue relating to the subscriber. I think the next speaker is going to give a diametrically opposed view on that. He is from a bank.

The last issue is retrospectivity. I have seen now that people are in fact asking for indemnities to cover retrospectivity. That is certainly an issue which I think is totally dependent upon your negotiating position. The way legislation is currently being passed there is very little likelihood of retrospective legislation getting through the Senate anyway, so that if you are the issuer it is not an indemnity that you would fight all that hard over. Certainly it is one that you would not want to give but nevertheless in terms of negotiating in the trade off of which ones you give and which ones you don't, that is not one that you would fight too hard over. The point of it simply is that if in fact a subscriber has been paid dividends and section 46 is amended retrospectively then there is nothing you can do about it under most existing documents. So that people are now asking for cover to gross up the previous dividends they have received. I think the chances of retrospective legislation are so remote, that it is an indemnity that one wouldn't fight all that hard.

Comment: P. Weaving

We regard tax indemnities as essential. It helps to get the agreed yield, which is fixed at the outset and to cover any possible changes in the legislation. We have not encountered any difficulties in getting issuers to agree to this. As a matter of fact such indemnities are usually offered. They are regarded as normal. I think if we go back to the origin of redeemable preference share financing we find that it originated in Canada.

Canadian banks thought it was the greatest thing since 'sliced bread'. They abused the system so much that they got into tax loss situations and the authorities invoked certain sections and put in new legislation under the taxation legislation. I believe, or the A.N.Z. Bank's view is, that if the market is suddenly flooded with a huge amount of R.P.S. finance then they will take the same view as they had with equity leverage leasing. It results in a deferral of tax and it decreases the revenue base. There is already a section in the Income Tax legislation, i.e. section 50(a) which will allow the tax office to impute a notional interest expense figure to be deducted against the dividend income, thus reducing the after tax yield on the investment. As I understand it, this is what happened in Canada.

THE SECONDARY MARKET

Comment: R.J. Nettleton

Perhaps I could briefly refer to certain problems that arise in connection with the secondary market.

The secondary market basically means that the original subscriber of the shares may want to sell his shares before the redemption date. One particular problem is in New South Wales; preference shares which have a redemption date within the next 24 months following the transfer are short dated marketable securities and there is a special rate of stamp duty attributable to them. This rate is .025 cents per $100.00 of the consideration in respect of each month or fraction of a month to the date of redemption from the date of transfer. So that would have to be watched. The other thing you have to be careful about on a transfer is to ensure that the letter of credit extends in favour of the transferee; this is often dealt with by providing that the original letter of credit would be cancelled and a new letter of credit issued if application is made by the holder of the benefit of it. The same applies also to the put option. That also would have to be novated or a fresh one granted. Again it is usual for this to be covered in the documentation where transfer of the shares is a possibility.

Comment: M. Perry

Given the time, I will abbreviate my comments. There is presently a limited private market in secured financing issues. It is somewhat limited because of the stamp duty problem particularly at the long end. Also, overseas banks issuing L.C.s don't always like to have them freely transferable. Some of them preclude any transfer and others require prior approval. One thing that does assist in the transferability is the use of a trustee to hold such security on behalf of holders in due course.

Another factor which I think will continue to inhibit secured issues as a secondary market instrument will be the more and more complex indemnities and the more and more complex structures. Continually evolving type of structures and indemnities may result in market standards being very different from year to year. Those issues entered into this year may not, therefore, be acceptable to investors at a later time and thus not be marketable.

In terms of the public market, of course, preference shares have been listed on stock markets for some time and again stamp duty has inhibited the development of that market and there is generally very little turnover.

Rebateable notes achieve many of the benefits of a secondary market, in that, when the issue matures and a new issue is made, the investors then have an option whether to invest or not at prevailing market rates. But it certainly is not the creation of a secondary market but rather the creation of continuing accommodation through reissuance of preferential shares.

Finally, and again putting on my adviser's hat, I think that one thing that an issuer has to be aware of is, in a secondary market, who in fact ends up holding the securities and what influence they may have over the company, particularly if there is an option to convert into ordinary equity or if there are some voting aspects related to the shares.