ACQUISITION FINANCING - SECTION 129

GERRY FEWSTER

Arthur Robinson & Hedderwicks
Solicitors, Victoria

I would also like to start with a caveat to draw your attention to section 38 of the Interpretation and Miscellaneous Provisions Act which makes it an offence for somebody to counsel the commission of an offence under the Code. I want to make it absolutely clear to you that what I am about to suggest is by no means counselling nor is it, under section 38(2), attempting to counsel. I am not sure I know how to attempt to counsel; it is perhaps like the sign on the Star Ferry in Hong Kong which says "spitting and attempting to spit is an offence".

With that caveat I would like to turn my remarks to the type of takeover situation which I think we encounter more perhaps than the public type takeover which has been discussed a little earlier. And there I am not suggesting they are unimportant but I think in daily practice it is the private takeover of the private company that we strike more often.

Very briefly the three principal prohibitions of section 129 are, as you no doubt all know, the prohibition against financing by a company of the acquisition of shares in that company or in its holding company; a prohibition against a company acquiring shares in itself or its holding company, and a prohibition against a company lending money on the security of its shares or its holding company's shares.

And I think of these the first, the giving of financial assistance, is the one that is most encountered in practice. There are exceptions to all of the prohibitions, in particular section 129(10) provides a mechanism for authorisation whereby the prohibitions may be avoided. That mechanism may be a considerable step forward from the position that existed prior to the Code but it suffers from some disadvantages. They may or may not be of concern in any given case but my experience is that once a client has decided to embark on a particular course, anything that delays him for more than an hour is regarded by him as a disaster of about 8.6 on the Richter Scale.

The principal disadvantage is, of course, as I mentioned, delay. If everything went perfectly I would think that you could theoretically complete the required procedure in about 23 days.

But as a matter of practicality it would take a minimum of a month and probably two or three months.

Secondly, the adoption of the authorisation procedure will not necessarily result in the proposed financial assistance being allowable, because you may strike opposition from creditors, shareholders or the Corporate Affairs Commission.

And thirdly, the notice of the meeting of shareholders which is necessary to be given must contain a statement as to the effect that the giving of the financial assistance would have on the financial position of the company and a copy of that notice has to be lodged with the Corporate Affairs Commission.

I am inclined to think that the authorisation procedure is likely to be of most use in the case of the relatively small proprietary company and, generally, those that are exempt proprietary companies. And as a result the companies will be obliged to disclose in considerable detail their financial affairs, something that many of them will be unwilling to do.

If because of delay or uncertainty as to success or the need for disclosure, the procedure under section 129(10) lacks attractiveness, then are there other methods of achieving the desired result without the attendant disadvantages? Well obviously there must be or I wouldn't have posed the question. Let me outline for you four methods by which it is possible to avoid this prohibition against the giving of financial assistance.

First of all section 129 prohibits only the giving of financial assistance for the purchase of shares. It is often overlooked that there exists a type of company which may, but does not necessarily, have a share capital - the company limited by guarantee. There are many such companies but in general they are not companies which are involved in commercial activities. Many golf clubs and social clubs and charitable organisations and so on are companies limited by guarantee and indeed this very Association is such a company.

So, putting aside for a moment the fact that a company limited by guarantee can have shares, let us assume that we have got one like this Association which has no shares and let us suppose that a company group consists of a holding company with three subsidiaries. Neither the holding company nor the subsidiaries can give financial assistance for the purchase of shares in the holding company. However, the holding company could form a company limited by guarantee, transfer all of the shares in the subsidiaries to the "guarantee company" in exchange for being admitted as a member of the guarantee company, or for a cash price which is to be paid in the future. We now have the structure of a holding company and a guarantee company with three subsidiaries.

The impecunious would-be purchaser of the shares in the holding company can now achieve the desired result by buying out the holding company's membership of the guarantee company using a loan from the subsidiaries. The method of buying depends upon the course followed in setting up the guarantee company; that is, whether the holding company simply exchanged its shares in the subsidiaries for its membership in the guarantee company or whether it became a member of the guarantee company and agreed to pay a cash price in the future.

If the exchange were simply the price of membership, then the purchaser is admitted to membership of the guarantee company, pays the holding company what would have been the price for its shares to resign as a member, using funds borrowed from the subsidiaries, thus leaving the purchaser as the sole member of the guarantee company, which is then of course the owner of the subsidiaries.

On the other hand if the transaction involved the future payment by the guarantee company to the holding company, then the purchaser simply pays an "entrance fee", as you would to a golf club, only slightly more perhaps, and becomes a member of the guarantee company using funds borrowed from the subsidiaries and the guarantee company then uses the entrance fee to pay off the debt to its former holding company.

Now, there are many permutations of that procedure so that the holding company can remain a member of the guarantee company along with the purchaser and the relative proportions of ownership can readily be provided for, but that is just a detail. The feature of the procedure is that no acquisition of shares is involved and therefore there is no prohibition under section 129 against the giving of financial assistance.

The first method that I have just mentioned is perhaps a little esoteric from the client's point of view and may not appeal to him, so let me suggest a more straightforward method which may be appropriate in some circumstances.

Let us suppose that A and B each own 50% of Amalgamated Antimacassars Pty. Ltd. and A wishes to buy out B. Amalgamated cannot lend A money for the purpose of buying out the shares held by B. So the first step is for A and B each to form a company and transfer their shares to that company. Amalgamated is now owned as to 50% each by A Pty. Ltd. and B Pty. Ltd. Neither of those companies is a holding company of Amalgamated within the definition of the Code, and accordingly there is no prohibition against Amalgamated giving financial assistance for the purchase of the shares in B Pty. Ltd. by A or A Pty. Ltd.

The third method of avoiding the disadvantages of section 129 is the use of an unlimited company. Such a company is not confronted with the restrictions on the reduction of capital that the limited company is and can reduce capital simply by passing a resolution to that effect. It is clear therefore that by converting to an unlimited company and then reducing capital, it is possible for the purchase of the company's shares to be financed.

But I sound a note of caution. Section 129(8) expressly excludes from the prohibition on giving financial assistance a payment made by a company pursuant to a reduction of capital in accordance with section 123. Unhappily section 123 is expressed not to apply to an unlimited company with the result that the express exclusion from section 129 doesn't apply. However, section 129(8) also provides that nothing in that sub-section shall be construed as implying that a particular act of a company would but for that sub-section be prohibited by sub-section (1).

Having regard to the underlying philosophy of the rule against giving financial assistance, namely to protect the creditors and shareholders, there seems no logical reason why an unlimited company should not give financial assistance in this way, for the members remain liable for the company's debts. Nevertheless, I think there is a different way of achieving the same result using an unlimited company and which I don't think anybody could argue with.

If the company has substantial liquid assets which are not required for its operations, after conversion to an unlimited company those assets can be distributed to the then members. That then reduces the value of the unlimited company and perhaps makes it easier for the purchaser to buy into the company.

Now there are obvious disadvantages with an unlimited company of course, but they can usually be overcome by interposing a limited company between it and the "real" shareholders.

The fourth method is one with which you are all familiar but for some reason is often overlooked. There is no prohibition against giving financial assistance for the purchase of a company's assets. And indeed it would be quite illogical and unworkable for there to be such a prohibition, because no retailer could ever sell goods on credit if there were. In many cases it will be convenient, and perhaps advantageous, to purchase the assets of a company rather than its shares and I am sure you have all had plenty of experience of that. That avoids any problems of the prohibitions of section 129 altogether.

In any of these four possibilities we would always have to take into account questions of tax and stamp duty. They are matters that come up in any sort of acquisition and it is simply a matter of designing the transaction in a way which as far as possible will minimise those imposts.

We should also not lose sight of section 229, which requires directors to act honestly and with a reasonable degree of care and diligence and adopting one or other of these courses might, in some circumstances, give rise to questions as to whether directors were in fact so acting.

And finally, of course, there is the prohibition against loans to directors in section 230, another little trap that ought not to be overlooked. But I would suggest to you that the prohibitions in section 129 are not all that difficult to avoid, at least in those cases which don't involve a listed company.