LEGAL ASPECTS OF FINANCING MANAGEMENT BUYOUTS AND PRIVATISATION

CHRISTOPHER STILL

Rothschild Australia Ltd, Sydney

The developments in the 1980s of the phenomenon known as privatisation has given rise to a number of concepts which had previously received little attention from the financial advisory and legal sectors. Of particular interest to the legal fraternity, I believe, is the development in the United Kingdom of the concept of Special Shares or as they are commonly known, golden shares.

In my paper this morning I would like to cover a number of points relating to Special Shares. First, the development of the concept itself, their purpose, the mechanics of a Special Share, how they have worked in practice, Australian precedents and finally, alternatives to Special Shares.

Development

Prior to the privatisation of Amersham International in 1982 the British Government relied upon a substantial shareholding to protect its interests in respect of those companies in which it was not the sole or majority shareholder. However, with the privatisation of Amersham, the government established the precedent of the Special Share in order to allow it to sell its entire "economic" interest in the company but still retain some safeguards against unwanted ownership or control. It is important to recognise that the purpose of the Special Share is not to allow the government to interfere in the commercial decisions of the company concerned. It is this premise which makes them acceptable to the market place. Since 1982 they have been used in all but three UK privatisations by public floatation.

What then led to the development of the Special Share concept? In the UK there appears to have been five principal motivations:

(i) there is a perceived need to allow the board of a privatised company a period in which to adjust to the disciplines associated with the private sector;

(ii) there may be a desire to protect a national asset against foreign ownership or foreign control;

(iii) there may be a desire to maintain the on-going independence of newly-privatised companies;

(iv) there may also be a desire to maintain wide UK share ownership by restricting the ability of any one party (or grouping) to accumulate a large shareholding; and

(v) there is the political need to avoid the embarrassment of an offer being made for a newly-privatised company shortly after floatation at a price above the issue price.

Mechanics

If these are its purpose, how then does a Special Share work? In brief, the ordinary share capital of the company is offered to the public and the Minister of the government department which sponsored the privatisation retains a Special Rights Preference Share. The Articles of Association of the privatised company contain special provisions which cannot be altered without the approval of this Special Shareholder and which in some cases also give him voting control of any resolution placed before the Company in general meeting. The Articles therefore establish the rules and the Special Share precludes any changes in those rules.

The rules themselves will reflect one or more of the government policies which I have already mentioned.

For example, if the government's aim is to ensure that the company being privatised will remain independent then the Articles will typically include a provision which limits individual shareholdings to 15 percent of the issued capital of the company. The directors of the company are obliged to monitor the share register and if necessary, force divestiture of shareholdings above that level.

With a similar aim in mind an alternative structure employed by the UK government in the privatisations of Britoil and Enterprise Oil was to give the Special Shareholder a majority voting entitlement if one party acquired more than 50 percent of the ordinary share capital.

The existence of such express or implicit restrictions on individual shareholdings does not prevent the privatised company itself from transferring control of its business to another party. Special Shares frequently therefore prevent the management of the privatised company from selling a substantial part of its business or from placing the company in voluntary liquidation without the government's approval.

These then are the principal means by which the British Government is ensured of having some control over ownership of the business of the company being privatised.

There is also precedent in the United Kingdom for special provisions to restrict the level of foreign ownership and

control. In the cases of British Aerospace and Rolls-Royce the aggregate level of foreign shareholding is limited to 15 percent of the issued capital. The Articles of some privatised companies also require that the majority of directors and/or the Chief Executive be British citizens.

The extent to which the Articles of a privatised company include some or all such provisions will vary from company to company depending on the company's activities, their national significance and government policy.

A final comment on the powers of Special Shares is that if they are to be effective the Articles must preclude the issue of shares with differential voting rights or alterations to the rights of existing shares if such an issue or alteration will lessen the power of the Special Shareholder.

While the government may wish to have safeguards in place at the time of privatisation, it may not wish to protect a privatised company from takeover in perpetuity nor preclude it from foreign investors.

Accordingly, one of the key considerations for the government will be whether or not the Special Share is to be redeemable, and if so, whether redemption should occur automatically on a given date, whether redemption should be at the discretion of the government alone, or whether redemption would require the agreement of both the government and the company. Suffice to say that precedents vary in the United Kingdom, reflecting both political and market considerations including the extent to which the business concerned is related to the defence industry and the extent to which the activities of a privatised company are also carried on by other organisations.

Special Shares in the Light of the BP Offer for Britoil

I would like now to mention the takeover of Britoil in late 1987 as an example of how Special Shares have worked, or perhaps more accurately in this case, have not worked in practice. As I mentioned earlier, Britoil's Articles and Special Share did not include a provision limiting individual shareholdings but rather only entitled the government to a majority of the votes once a third party shareholding exceeded 50 percent.

Until the end of 1987 the market believed that this made Britoil immune from takeover. BP on the other hand had different ideas and announced an offer for the company on the 18th of December, 1987.

Even before taking account of the political considerations, this posed a dilemma as the City Code on Takeovers and Mergers does not consider the concept of a Special Share and in broad terms provides that an offer cannot be declared unconditional unless the offeror becomes entitled to shares carrying over 50 percent

of the voting rights. The Special Share technically meant that BP could have acquired 100 percent of the ordinary shares in Britoil and yet not have a majority of the voting entitlement. In theory BP would not therefore have been able to declare the offer unconditional and shareholders would have been denied the opportunity to determine the merits of its offer. The takeover panel in fact allowed BP's offer for Britoil to proceed and as a result it acquired 100 percent of Britoil's ordinary share capital. In response the British Government chose not to exercise its special voting rights but negotiated with BP certain agreements as to the continued operations of Britoil. The Special Share, however, remains in place.

What then are the ramifications of the Britoil takeover for the use of Special Shares?

First, it seems that an implicit restriction on share ownership as contained in the Britoil Articles is not sufficient protection for the government. If economic control has passed it is difficult for the Special Shareholder to ignore the rights of a holder of a majority of the equity. Indeed there is a suggestion that if the government wished to exercise control in such circumstances the directors might be placed in breach of their fiduciary duties.

If we are to adopt the Special Share concept in Australia so as to protect the independence of privatised companies, we must then, it seems to me, look at imposing a shareholding threshold which is below that level at which control might pass. As I have mentioned this has been more typically achieved in UK privatisations by a 15 percent restriction on individual shareholdings and there is no evidence to suggest that this is ineffective.

In Australia the Australian Foreign Takeovers Act and the Bank Shareholdings Act also suggest that 15 percent is such a threshold. Section 11 of the Companies Acquisition of Shares Code suggests that 20 percent is not control while s.23 implies that 30 percent possibly constitutes some level of influence over a company. In mentioning the Acquisition of Shares Code it is worth pointing out that in similar circumstances to the offer for Britoil the NCSC would not face the same dilemma which the London Takeover Panel faced, as the Australian legislation allows a minimum acceptance condition to be waived irrespective of the level of acceptance.

The discussion of Special Shares above has quite obviously focused on UK precedent. That is not to say, however, that there is not some useful Australian precedent.

In 1984 Rothschilds sponsored the listing of Wesfarmers Limited, a subsidiary of the Westralian Farmers Co-operative which took over responsibility for almost all the activities previously carried on by the co-operative. The Board of Wesfarmers was

concerned to ensure that the company remained independent. As a result, it was decided that some additional protection be included in its Articles and a Founder Share based on the Special Share concept was issued to the co-operative. This Founder Share provides that the co-operative will have a majority of the votes in the listed company if the co-operative has reasonable grounds to believe that its on-going independence might be threatened by a third party or if a resolution is proposed to modify or vary the rights of the holder of the Founder Share.

Alternatives to Special Shares

A Special Share is not the only means by which the government may retain some powers in respect of an organisation which has been privatised.

In 1986 Rothschilds advised the Jamaican Government on the privatisation of the largest commercial bank in that country. In this case it was felt that if the government held a Special Share in the bank, the bank would be too subject to the whims of a notoriously fluid political system. Accordingly, the restrictions that were placed on ownership of the bank shares and the sale of its assets were entrenched in the Memorandum of Association rather than the Articles. The Memorandum can now only be changed with the unanimous agreement of a shareholders' meeting at which there are present in person or by proxy, shareholders having 90 percent of the voting rights. As you would understand the chances of this occurring are rather remote.

In Australia this technique is permitted by s.73 of the Companies Code and indeed the Advance Bank, which was floated in Australia in 1985, uses its Memorandum of Association to entrench certain rights.

A more obvious method of providing the government with Special Share type safeguards is the use of legislation.

For example, the Bank Shareholdings Act already performs one of the principal functions of a Special Share: that is that no individual or corporation may acquire more than 15 percent of the issued capital of an Australian bank without the approval of the Governor General.

This type of legislation is not unique to the banking sector. Many of you will recall the "Santos" legislation introduced by the South Australian Government which required the Bond Corporation to reduce its shareholding in that company to less than 15 percent and which I understand still restricts individual shareholdings to that level. Here in Queensland an offer by Industrial Equity for Allgas was thwarted by similar legislation.

These then, I believe, are the principal means by which a government can protect a company which moves from the public to the private sector. In many cases a substantial responsibility

will fall on the directors of the company concerned and in any particular case the company, the government and their financial and legal advisors, will need to closely consider the political and commercial requirements and how they may be best accommodated.

It seems to me that a Special Share provides some advantages: it falls within the Companies Code and therefore the special controls should not require their own legislation. A Special Share may also provide a greater degree of flexibility than the use of the Memorandum of Association which if sufficiently tightly drafted might forever preclude changes to its provisions. A Special Share can be redeemed quite easily: on the other hand, Parliament would need to approve any alteration to legislation unless it included a sunset provision which in any event may or may not accommodate changing circumstances.

The conclusion from all of this is that there will be a lot of work to be done by the lawyers, should the Federal or State governments push ahead with the privatisation policy.