ACQUISITION FINANCING - SECTION 129

THE HONOURABLE MR JUSTICE MAHONEY

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Thank you Mr Chairman. May I say it is a great pleasure to be invited to speak at this conference. This kind of provision, the old section 67, is a provision for which I have had a great deal of affection. It provided me and my wife with a fine living when I was in practice at the Bar. Hardly a month went by when I didn't have some opportunity to charge a fee for and to display what was taken to be a great deal of insight when I showed somebody that section 67 arose in the transaction in circumstances where he never imagined it to be mildly relevant.

I have been asked to express views today upon the present section 129 which, as I shall assume, are expected to be profound. And I have been asked to express them in 10 minutes. Like the prospect of hanging, this serves to concentrate the mind enormously. I shall therefore say what I have to say briefly. If there is any profundity in it, I will expect that to be elicited during the course of discussion.

Before coming to my thesis I would place one condition on what I say. It is to be understood that what I say does not relate to particular cases either actual or potential, cases such as have been or may be before the courts. I speak only in terms of principle and as to a conference of lawyers expert in this particular field. You will understand that as a practicing judge I would normally add a caveat of that kind to what I say. In the circumstances of what has occurred between the date I received my invitation to come here and the present time it is particularly necessary that I add that kind of condition. And if John Noseworthy is here I would only add my firm assurance that the notes from which I am speaking were prepared long before the events occurred with which no doubt he will be concerned.

My thesis is that section 129 does not achieve the purpose for which it was designed and that it is time that this particular provision or kind of provision was re-thought and re-drafted.

What I want to do in the short time available is to suggest four propositions. They are these.

First, this section, this group of sections, prohibit companies using their assets in transactions which in particular cases may provide genuine commercial benefits for them and their shareholders.

Second, the restrictions which are presently imposed by the sections are not minimal or formal only but, I think, constitute a real and substantial restriction upon what businessmen may do.

Third, I know of no cost benefit analysis which has been done which suggests that there is any obvious benefit in the present form of the sections.

And fourth, I would suggest that the legislation would benefit from a careful reconsideration of the underlying rationale of it and of the extent to which the provisions that are now in force either go beyond that rationale or alternatively seek to give effect to the rationale by a mechanism which itself is defective and inefficient.

Let me go back and speak just briefly about each of those four propositions.

First, the sections prohibit companies from doing what legitimately they may want to do. Let me take only two examples of what is prevented by the section. In a takeover situation, and I emphasise this was written a considerable time ago, the stock exchange price of shares in a company is $1 per share, the offeror is prepared to pay $2 per share, he is able to obtain independent temporary bridging finance to enable him to pay the $2 per share, but can do so only on the basis that, when he obtains control of the company, the company will lend him an amount equal to $1 per share. Let me assume it is for the benefit of the shareholders that they are able to obtain twice what the market price of their shares is. But the company cannot promise the offeror (and more importantly, those who are going to finance him) that if he makes the offer the company will in due course make that loan to him. I assume that there is no fraud and that creditors are safeguarded, as in most cases happens. One may ask "Why should not the company be able to do that?".

The second example I take is: a company desires for sound commercial reasons to have X associated with the company by way inter alia of having him the owner of 25% of the paid up share capital. X does not have the money to subscribe for such fully paid shares. The company desires to lend him the money to enable him to acquire and pay for the shares. Again, on the assumption that there is no fraud and that the creditors are safeguarded and that the company receives genuine commercial benefit in having X so associated with it, why should it not be able to do that?

I have taken these examples to illustrate commercial transactions which are prohibited by the section. I do not complicate the examples by consideration of how the same result can be achieved by other means. No doubt those present will think of other and

equally pertinent commercial transactions which are prohibited by the section. And one would wonder why.

I go to the second proposition: that the present restrictions upon what a company may do in this regard are not minimal but are real and substantial. At the present time the legislation contains an absolute prohibition against financial assistance, unless the transaction be authorised by a special resolution (section 129(10)) which is not nullified by the court on somebody's application (section 129(12)).

One may infer that the provision, as to special resolution and the power of the court, was put into the legislation in order to mitigate the rigour of the absolute prohibition and so to make the section flexible. For myself, I would doubt whether it goes any great distance towards that. Let me suggest two obvious reasons why it does not. The first is that the means of removing the restriction are of course not available in the ordinary case to the person who would ordinarily wish to remove the restriction, for example a person making a takeover offer. He can hardly procure, in the case of a company whose Board is opposing his offer, that the company pass a special resolution to allow this kind of financial assistance to be given. And in practical terms those who would benefit from the removal of the restriction, namely the shareholders, are hardly in the practical sense in a position to put this machinery into operation.

The procedure for the removal of a restriction is, in practical terms, cumbersome. In other words, if you must have a special resolution, contemplate somebody applying to the court and a court hearing whether the special resolution ought to be nullified or not; in fact the ardour of the offeror is apt to be cooled and he will probably go somewhere else. And the shareholders who might have received $2 for their $1 share will be left with their shares.

I suggest that the procedure is cumbersome, to the extent that it leaves the practical effect of the section's restriction on commercial dealings as very substantial.

The third proposition: what is the cost benefit analysis of this situation? Properly drawn legislation will, ideally, allow commercial people to do what they want to do and, insofar as an abuse may arise, prevent them from doing what they want to do only if and insofar as it constitutes an abuse. In other words the legislation will prevent the abuse but allow the use.

The present section has prohibited the transactions absolutely, whether an abuse or not; and it then commits to a special resolution and/or the court the power to allow the transaction if it is shown not to be abuse. Consideration might be given, I think, to providing simply that a company may give relevant financial assistance but that any transaction may be set aside if it constitutes a breach of duty by the company or its directors in, let me assume, specified ways. If one looks at the simple

giving of financial assistance, the giving of financial assistance (leave aside the repurchase of your own shares for the moment which is a special case) is a neutral thing. It becomes bad insofar as the purpose for which it is done is bad. And therefore, if it were said by statute that it may be done, that is, financial assistance may be given, but it may be set aside if the purpose is bad, then I suspect a good deal of the abrasion and the inflexibility of the provisions, would be removed.

There are other mechanisms that might be suggested as variations of the present procedure, such as would enable a company to do what is commercially proper and yet restrain it from the abuse of the particular power. But again, they are matters that can be dealt with during the course of discussion.

What I have said is, I think, in accord with the philosophy that it is the abuse and not the use which should be legislated against. To make that philosophy effective it may be that there needs to be the equivalent in Company Law of an Ombudsman or a Director of Public Prosecutions who will, at the public cost, scrutinise and prosecute objectionable transactions and will not be subject to the kinds of restrictions to which the National Securities body presently is subject. This is a topic on which one could speak for a great deal of time. If there are other problems to be raised, perhaps we can raise them in discussion.