LEGAL ASPECTS OF FINANCING MANAGEMENT BUYOUTS AND PRIVATISATION

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I must confess to sharing David Saunders' fears about addressing you this morning. If I had known I was going to have to stand up here in front of 200 of you I think I would probably have found a prior engagement. But anyway - privatisation.

I think it is as well if I define what I believe is meant by privatisation. From our perspective it relates to the transfer of businesses from the States into private hands. It does not relate to a majority shareholder taking a company private by buying out the minority. This is perhaps a shame as the latter is certainly more topical at the moment with several transactions being carried out - whereas the leadership of the ALP seems to be having some trouble winning the privatisation debate. However it would appear inevitable that some form of privatisation is sure to come.

I should also reassure you that we are not going to become involved in the argument, in favour or otherwise, of selling the family silver as it is a subject which has been well debated and one in which most people have pretty set views. What we want to do is consider certain specific aspects of privatisation which are most relevant to the legal profession.

First we need to consider why privatisation is a subject in its own right and why it is different from any other sale or floatation of a private company. There are many reasons but I want to highlight four specific differences.

First, the interaction between governments and their civil servants with the private sector is always guaranteed to highlight differences and raise problems, particularly in that government objectives usually extend beyond the normal criterion of maximising profits. Secondly, the businesses which are privatised are often monopolies which need to be regulated prior to being released into the private sector. Thirdly, they are often of such a size as to potentially swamp the local financial markets. And finally, the sale of strategic national assets must contain provisions to protect those assets from predators - both local and overseas.

Stephen Franks will be looking at the problems and special tensions resulting from the transfer of assets from the public to the private sector. Regulation, whilst fascinating, I think is outside the ambit of today's discussions. Instead I want to focus on international equity offerings and the impact of the recent BP offerings. Whilst discussing BP I will touch on the underwriting agreement and the force majeure debate in the light of the stock market crash. Christopher Still will then discuss golden shares and other methods of ensuring that the family silver is protected.

Overseas offerings have become an integral part of the privatisation program world wide and have been used in amongst others, the UK, French, American and New Zealand issues, for a number of reasons. The sale of companies such as British Telecom and British Gas in the UK, Cornrail in the US, and Petracor in New Zealand, were large in the context of the domestic capital markets and international offerings enhance the size of the available markets.

Secondly, in maximising proceeds, it is important to create scarcity. Initially this may seem a hopeless task when selling companies the size of British Gas worth over 5 billion pounds. However, through effective marketing it is possible to generate considerable retail and overseas demand and thereby pressurise the local institutions who are the natural takers of stock into accepting a higher price.

The third reason for tapping overseas markets is that despite the growing internationalisation of markets they are still imperfect and various markets place a higher multiple on assets than others. An example is the British Ariways float. The floatation price was deemed cheap in the US by reference to the price of US Airlines and thereby considerable demand was generated. If those are the reasons for doing so, how easy is it? The simple answer is that it varies enormously. It depends on the amount of money raised, the markets to be accessed, and whether it is considered necessary or valuable to list overseas. There are two types of international offerings - those using the Eurobond route which we will refer to as Euroequities and those where simultaneous public offerings are made in more than one market. First let us look at Euroequities.

This generalisation covers the whole range of offers which are made in the Euromarket, be they primary or secondary issues. They do not involve additional listings and the documentation is minimal. It is based on the Eurobond system where the issue is syndicated in a relatively informal manner and as the stock is only offered to professional investors there are no national prospectus regulations to comply with.

From an Australian perspective this would cover either a secondary issue by way of placement with international institutions, or the international tranche of a primary issue which would again be placed with overseas institutions on the back of the Australian prospectus. Secondary issues have been fairly common and the Newmont issue last year was an example of a primary issue including an international tranche aimed at professional overseas investors. This is also the route that has been followed in the US, French and New Zealand offers.

The second category involves simultaneous public offerings and are primarily connected with the UK privatisation programs although other offers have been made including Reuters and the forthcoming float of the Racal Cellular Telephone System in the UK is likely to follow this route. In these instances, given the size of the offer, it was felt to be beneficial to target the major overseas markets of North America and Japan. And because of the selling restrictions imposed in these markets it was necessary to undertake fully registered offerings.

The Euroequity route taps a wide range of institutions. There is no doubt that a registered offering, possibly supported by a listing, offers a significantly wider audience of institutional and retail investors in Japan and North America and also guarantees a more liquid and informed after-market. In the case of British Gas, the regulatory regime was very different from the profit regulated system of the US, and therefore there was perceived to be considerable American demand which could only be accessed with a registered offering. In the BP issue US demand was estimated to be well over a billion pounds, which again would not have been tapped on the Euroequity route. However there are considerable problems involved in following this route because of the different regulatory regimes and market practice.

I would like to highlight just two of these procedural differences between the UK/Australian system and that of Japan and North America. The problems that these cause are integrated in the two systems. First is sub-underwriting. Whereas in the UK and here it is normal for institutional investors to sub-underwrite issues, this is not the case in the US. Whilst sub-underwriters are long term holders of equity, in the US the underwriters are dealers who because of their capital base have to be short term holders. The second point is the underwriting period which I think flows from the first point. Here and in the UK shares are applied for whereas in North America they are sold to investors. As we know here an offer is priced and underwritten and then marketed during the application period and eventually the shares are listed. Not so in the States. There the issue is announced and offered to the public by way of a red herring prospectus before the underwriting agreement is signed. Then at the end of the marketing period when the SCC registers the offer it is priced, the underwriting agreement is signed and sales are immediately made to the public. Accordingly there is only the shortest of underwriting periods.

The means of reconciling these two systems has evolved over time - for the initial British Telecom float through to the recent BP issue. For British Telecom the issue followed the standard UK approach with the issue priced and underwritten in the UK and after a seven day offering period dealings starting a few days later. The overseas underwriters did not sign their underwriting agreement at the beginning but waited until immediately prior to dealings commencing, which was again consistent with their normal practice. The underwriting exposure on this international tranche was covered by the Bank of England for this ten day period. The result, as I am sure most of you are aware, was that the American underwriters whilst morally obligated to underwrite were not bound to do so and when they did sign up they had the comfort of the considerable over-subscription in the UK. They therefore had a substantially risk-free investment on which they received fees considerably greater than their UK counterparts. This created some unhappiness especially when most of the US shares immediately returned to the UK on the commencement of dealing.

This system was not followed in British Gas and a major breakthrough was achieved. Here the US investment banks and their counterparties in Japan and Canada were persuaded to enter into their underwriting commitment on the same day as the UK underwriters. Accordingly they agreed to a two week underwriting period without the safety net of sub-underwriting. This was also the position with the BP issue in October last year. The consequence is well known. The offer period straddled the crash and the offer closed heavily under-subscribed. The UK and European tranches were sub-underwritten whereas those in Canada and the US were left with the underwriters who were unable to distribute any shares at the offer price.

Where then does this leave international equity offerings? First, I believe that despite the setback, the internationalisation of markets will continue as issues exceed the capacity of local markets. And there will also continue to be a demand in the major markets for quality overseas stocks. Secondly, it is also likely that the Euroequity route will become more popular with only a limited number of issues opting for the simultaneous public offering route. These will be the very largest issues and those such as the Racal offer which I mentioned earlier where the American market clearly has a greater understanding of the product.

From the Australian perspective the Euro route is also the likely choice unless it is decided to float say the whole of Qantas in one go where it might be desirable to tap the American and Japanese markets directly.

Finally, it is also clear that underwriters will analyse risk more carefully. By the end of the bull market underwriting, and to some extent sub-underwriting, was deemed to be riskless, especially when there was a perception that governments would not allow an issue to fail.

This brings me on to the BP underwriting agreement and the whole debate about the force majeure clause in the light of the crash.

The first thing to say about the clause was that there could be no termination of the underwriting agreement without the Treasury's consent. The actual process towards termination was as follows. If a majority of the UK, not anyone else but the UK underwriters believed there had been any adverse change in national or international financial, political, industrial, economic conditions or exchange rates, which was of such magnitude and severity as to be material in the context of the offer and which should not be regarded as a proper underwriting risk, again in the context of the offer, then the underwriters should meet the Treasury to consider terminating the offer.

If the two parties could not agree then they should jointly consult the Bank of England, and the Treasury, before taking a decision, were to take full account of the bank's assessment. In the light of the unprecedented falls world-wide the UK underwriters decided there had been an adverse change which was material - it was not a proper underwriting risk and requested consultation with the Treasury. The Treasury, having taken account of the bank's advice, decided that the issue should still proceed, although they agreed that the Bank of England would support the issue by standing in the market for a limited period at a price of 70 pence against the first instalment price of one pound twenty pence, thereby underpinning the market.

There are several points, I think, which are pertinent. First, the BP issue was the first UK privatisation where there was a single underwriting agreement covering all overseas offerings and it was governed by UK law. Previously there had been individual agreements with local law governing each agreement. Secondly, the international underwriters were not party to any of the discussions or consultations regarding force majeure as it was purely a matter between the UK underwriters and the Treasury. Although they were clearly given an opportunity to present their view, they did not have an official forum which was ironic given that due to their underwriting procedures they had the largest positions. The US syndicate of four banks was unable to spread their risk whereas the UK underwriters had subbed this risk either totally or substantially so.

The position of the overseas underwriters was not mirrored by the reaction of some UK sub-underwriters. The UK sub-underwriters who obviously had a fairly small exposure argued that the issue should proceed regardless of the extent of the market crash as they believed it clearly vindicated the need for sub-underwriting which had been increasingly questioned as a result partly of the bull market and also the influx of practices from across the Atlantic.

Finally, from a legal perspective, the whole clause was clearly subjective, with the UK underwriters being required to consider whether it was a proper underwriting risk. I would imagine that consideration of risk could keep your profession busy for a long and profitable time. Hopefully you will not take advantage of my lack of legal knowledge to ask me to define a proper underwriting risk but it clearly relates to whether the events are deemed to be exceptional or not.

It is also clear to me in the few months that I have been here that Australian underwriting agreements are less onerous on underwriters and more specific, with definitive clauses relating to falls in market indices etc. However I would like to leave you with a question and that is whether you believe the Australian government would be prepared to incur the expense of underwriting an issue if when needed the underwriters could withdraw and leave the government with a public embarrassment of having both the failure and being left with the stock? At least in BP the UK government could claim that they had received an excellent price. The UK government have always taken the view that underwriting fees are only worth paying because they are guaranteed proceeds regardless of market changes and that when they publicly announce the sale, the issue is sold and in the private sector. Finally on this point, I think it is interesting to see that the recent Victorian Equity Trust underwriting agreement could be terminated if the all ordinaries index fell 10 percent and it will be interesting to see what line future governments take. I would now like to hand over to Christopher Still.