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Takeover Financing in Australia

Material prejudice and financial assistance – Chapter 2J.3 of the Corporations Act

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For takeover financiers one of the chief obstacles to achieving satisfactory security for the financing is the financial assistance prohibition in section 260A(1) of the *Corporations Act 2001* (Cth)[1]. That section provides as follows.

(1) A company may financially assist a person to acquire shares (or units of shares) in the company or a holding company of the company only if:

(a) giving the assistance does not materially prejudice:

(i) the interests of the company or its shareholders; or

(ii) the company's ability to pay its creditors; or

(b) the assistance is approved by shareholders under section 260B (that section also requires advance notice to ASIC); or

(c) the assistance is exempted under section 260C.

The section prevents a target company (***target***) giving financial assistance, usually in the form of guarantees or securities, in connection with the acquisition of shares (or units) in itself or in its holding company. The original purpose of the prohibition was to prevent bidders using the assets of the target to fund its acquisition. Its effect (unless an exception applies) is to keep the financiers of a takeover in a subordinated position *vis à vis* existing creditors of the target.

The current form of the prohibition derives from an attempt, in the last years of the 20th Century, to simplify and relax the prohibition, principally by introducing the 'no material prejudice' exemption set out in paragraph (a) of s260A(1), as set out above. Through poor drafting and an inadequate understanding of how the prohibition operates in practice, that attempt has failed. The main alternative route around the prohibition, the shareholder approval or 'whitewash' procedure, is also beset with practical difficulties.

There is a strong argument for the abolition of the financial assistance prohibition. Most of the worthwhile protection afforded by the prohibition is already covered by the enhanced directors' duties, corporate governance and disclosure regimes, the remedies for oppression and the sanctions for insolvent trading. This paper canvasses the inadequacies of the 'no material prejudice' exception, difficulties with the shareholder approval process and some other grey areas, highlighting the current risks that the section presents to financiers as well as company directors. I also make some practical suggestions about how best to live with the section while we await reform.

Background

Although the curiously inverted (permissive) language of the prohibition suggests that financial assistance has always been unlawful (presumably as a form of unauthorised reduction of capital), in fact it has not,

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[1]: In this paper all references to sections will be to sections of the *Corporations Act 2001* (Cth) unless otherwise stated. The paper is current as at 1 August 2014. The material prejudice discussion is derived from an earlier article by the author: 'Material prejudice and financial assistance: The financier's viewpoint' (2004) 78 *Australian Law Journal* 746, which addresses some of the arguments in greater detail.

and the prohibition was only introduced following a recommendation by the UK Greene Committee in 1926. The Greene Committee had reported that:

> A practice has made its appearance in recent years which we consider to be highly improper. A syndicate agrees to purchase from the existing shareholders sufficient shares to control the company, the purchase money is provided by a temporary loan from a bank for a day or two, the syndicate's nominees are appointed directors in place of the old board and immediately proceed to lend to the syndicate out of the company's funds (often without security) the money required to pay off the bank. Thus is a typical example although there are, of course, many variations. Such an arrangement appears to us to offend against the spirit if not the letter of the law which prohibits a company from trafficking in its own shares and the practice is open to the gravest abuses.

In other words the prohibition is not so much about reductions of capital as preventing a specifically identified abuse. A continuation of the prohibition was affirmed by the Jenkins Committee in 1962, and the Committee noted that in the 'classic' scenario of a raider using the assets of the target to fund its acquisition:

> If the speculation succeeds, the company and therefore its target's creditors and minority shareholders may suffer no loss, although their interests will have been subjected to an illegitimate risk; if it fails, it may be little consolation for creditors and minority shareholders to know that the directors are liable for misfeasance.[2]

As originally enacted in Australia,[3] there was no way around the prohibition, which had a prophylactic purpose. Subsequently, a cumbersome shareholder approval mechanism was introduced.[4] The old prohibition was also beset with uncertainty, with contention for and against an overriding *impoverishment* concept[5]. An attempt at relaxation and clarification came in 1998 when the current version of the financial assistance prohibition was enacted by the *Company Law Review Act* 1998 (Cth), most notably featuring a statutory version of the impoverishment test, the no material prejudice exception, explained as follows (in the Explanatory Memorandum to the Bill (paragraph 12.76).

> This approach is intended to minimise the difficulties the rule currently causes for ordinary commercial transactions. In particular, for transactions which do not involve material prejudice, the new rules will make it unnecessary to decide whether the transaction involves the giving of financial assistance.

The baseline question – 'Financially assist a person to acquire shares'

The kinds of transactions that may fall within the concept 'financially assist a person to acquire shares' are more or less unlimited. Although the definition has been dropped from the *Corporations Act*, the meaning of financial assistance is unchanged – loans, guarantees, securities, asset purchases and the like can all be caught when given by the target or any of its subsidiaries. This includes financial

2 *Report of the Company Law Amendment Committee*, HMSO, Cmd 1749 of 1962, paragraph 173.

3 Eg *Companies Act 1967* (NSW) s 67.

4 *Companies Act 1981* (ACT) s 129(10) (and related Companies Codes). This exception had been recommended by the Jenkins Committee in 1962!

5 An idea originating with Hutley JA in *Burton v Palmer* [1980] 2 NSWLR 878. Indeed, although a series of cases had relegated the idea to the status of 'no more than a helpful guide' (*Re National Mutual Royal Bank Ltd* (1990) 8 ACLC 1057, *Dempster* v *NCSC* (1993) 11 ACLC 576, *Milburn* v *Pivot Ltd* (1997) 15 ACLC 1520, *Sterileair Pty Ltd* v *Papallo* (1998) 29 ACSR 461 and *Wall St (Holdings)* v *Wambo Mining Corp* (1996) 14 ACLC 1 (Gleeson CJ) and, on appeal, (1998) 16 ACLC 1601), Young J in *Tallglen Pty Ltd* v *Optus Communications* (1998) 16 ACLC 1526 held that he was bound to adopt the impoverishment test. Having done that, however, his Honour devalued the test by finding that the issue of options to take up shares at substantially less than their market value does not diminish a company's financial resources (even though it adversely affects its ability to raise further capital).

assistance in the form of a dividend (s 260A(2)(b)). The concept of acquisition is similarly broad and notably extends to include, among other actions, the *issue* of a share or unit, and *units* include options[6].

The 1998 amendments also dropped the phrases 'purpose of or in connection with' and 'directly or indirectly' in favour of the simple preposition 'to', potentially broadening the prohibition but also helping prevent its application in more tenuous situations. There is no longer a purpose test, just an objective question: **does it financially assist a person to acquire the shares?** Purpose and mere connections are less relevant; common sense rules – the old law was already headed in this direction, see *Sterileair Pty Ltd* v *Papallo* (1998) 29 ACSR 461. It is also clear from s 260A(2)(a) that, despite the doubt that arose from the decision in *Tallglen Pty Ltd v Optus Communications* (1998) 16 ACLC 1526, the timing of the assistance does not matter – it can occur before or after the acquisition in question.[7]

As a result of the broad construction of the concepts involved, the baseline question is in general easily answered in the affirmative. The real issue in most cases of alleged financial assistance will relate to the question of material prejudice.

Relaxing the restriction? The material prejudice test

The 'no material prejudice test' is the most fraught area of the financial assistance prohibition. The Explanatory Memorandum for the 1998 Australian legislative reforms stated that the 'no material prejudice' exception was intended to relax the financial assistance rules and avoid the expense of members meetings for 'a range of ordinary commercial transactions'.[8] That, of course, is a question-begging statement, but it is surely a bold move to say that the very sort of transaction for which the prohibition was created, a target using its financial resources to assist the bidder to fund the takeover, was ever intended to be classified as an ordinary commercial transaction.

There are said to be two 'limbs' to the test of whether a transaction involves material prejudice – first, whether the financial assistance materially prejudices the interests of the company or its shareholders and second, whether the financial assistance materially prejudices the company's ability to pay its creditors. If the financial assistance does neither, it will escape the prohibition. The person contesting that the financial assistance prohibition does not apply bears the onus of showing an absence of material prejudice.[9]

The dysfunctional disjunctive: material prejudice to the interest of the company *or* its shareholders

In regard to the first limb of the material prejudice enquiry, an absence of prejudice to the target or its shareholders, the interests of a company are usually thought to coincide with the interests of its shareholders as a whole.[10] And in a classic takeover where the bidder acquires 100% of the target the giving of guarantees and securities by the target in relation to the takeover finance raised by the bidder

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6 Section 260A(3)(a). In *Re Tempo Services* (1997) 25 ASCR 528 it was ventured that 'units of shares' may even extend to options for unissued shares.

7 For a good discussion of the 'link' between acquisition and assistance see the judgment of Austin J in *Law Society of New South Wales v Milios* (1999) 48 NSWLR 409.

8 Explanatory Memorandum, *Company Law Review Bill 1998* (Cth), paragraph 12.76.

9 *Re HIH Insurance Limited; Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253, 343; *Kinarra Pty Ltd v On Q Group Ltd* (2008) 65 ASCR 438, 441-442.

10 In the context of director's duties it has been said to be fallacious to distinguish the interests of the company from the interests of corporators: *Japan Abrasive Materials Pty Ltd v Australian Fused Material Pty Ltd* (1998) 16 ACLC 1172, 1178.

(which is now the sole shareholder) will clearly be in the interests of the shareholder. However, the legislature has chosen a disjunctive, so the reference to the company *or* its shareholders must also require consideration of the position of the company as an independent entity, separate from its shareholders.[11] In other words there are two branches of the first limb.

That would be consistent with some of the key financial assistance cases which suggest that the principal focus is on the interests of the company as a separate entity, with little explicit regard being paid to the position of the shareholders.[12] For example, in the leading case to date on the meaning of 'material prejudice', *Re HIH Insurance Limited; Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253 at 340-343, the judge focussed almost exclusively on the impact of the relevant transactions on (for our purposes) the target, rather than its shareholder (HIH).

In that case, Mr Justice Santow identified the question as being: after looking at the interlocking elements of the transaction, where does the net balance of financial advantage lie?[13] Applying this test to the classic takeover financing scenario, the target:

- puts all its assets at risk, as security for the finance raised by the bidder for its acquisition of shares in the target,

in exchange for:

- some potential benefits of an intangible nature, such as, possibly, new management and/or synergies through integration with other businesses of the acquirer, and rights of contribution or subrogation of variable (but usually low) value.

The 'net transfer value' is not favourable to the target, even if the probability of call on its guarantee or security is low. Bear in mind, too, the comments under the heading 'Onus of proof and the issue of hindsight' below, and that the ready availability of the shareholder approval option will also work against a reading down of the test.

Material prejudice to the company's ability to pay its creditors

The second limb of the cumulative requirements to make out the no material prejudice defence considers the impact of the financial assistance on the target's ability to pay its creditors. This limb also presents an interpretational challenge: is it an absolute test (so that if the target remains solvent it is satisfied) or relative? The prudent course, supported by judicial consideration of the same test in a slightly different context[14], is to assume the latter.

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11 Generally the interests of the company are equated with those of its shareholders. But distinctions can be drawn. A company acting in its own interests solely might well pursue a course – for instance in relation to dividend policy – which is inconsistent with at least the short term interests of its shareholders. Similarly, you would have to ask when a members' voluntary winding up serves the interests of the corporate entity although it may suit current shareholders. The 'interests of the shareholders' test in s 260(1)(a)(i) has a degree of immediacy about it which the classic corporate benefit formulation does not.

12 In the more recent case of *Kinarra Pty Ltd v On Q Group Ltd* [2008] VSC 12, Robson J adopted the *ASIC v Adler* approach and carefully distinguished between the interests of the company and its shareholders (material prejudice to creditors was not argued). At [26] his Honour stated that 'the elements of financial assistance and material prejudice are linked. That is, the financial assistance to the acquirer is affected [*sic*] by the company transferring net value to the acquirer which may be prejudicial to the company whose shares are being acquired, its shareholders or creditors.' Hi Honour also made an *obiter dicta* suggestion at [31] that a 20% dilution of shareholder equity, even in circumstances where the assets and liabilities of the company remained unchanged, would constitute material prejudice to shareholders (but not to the company).

13 *Re HIH Insurance Limited; Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253, 339; also approving similar statements in Ford H, Austin R and Ramsay I, *Ford's Principles of Corporations Law* (Butterworths Online subscription service) at [24-710], http://www.butterworthsonline.com viewed 8 July 2014.

14 Refer *Re CSR Ltd [2010] FCAFC 34*.

It has been suggested that in interpreting this requirement there is a choice to be made between a cashflow test and a balance sheet test. Some come down in favour of the cashflow test, rejecting the balance sheet test for various reasons, including the likelihood of it being failed.[15]

The legislature, of course, does not mandate either test, or a choice between them. There is no reason why both the balance sheet and cashflow impacts would not be considered. In *ASIC v Adler* Santow J adopted Ford's proposition that 'the law will… apply to a transaction which involves conversion of a company asset into one of lesser quality (for example where cash is converted into a unsecured loan without interest to the purchaser of shares)'.[16] His Honour examined not the cashflow impact of the transactions but the net detriment to the company from a poor bargain. While the target may get some benefit (possibly through access to the resources of the new shareholders and/or greater management skills or synergies with the existing business of the new shareholders), those benefits are tenuous and intangible in contrast to the balance sheet impact, and potential cashflow impact, of guaranteeing the bidder's takeover finance debt, and of undertaking any related upstreaming obligations.

Ford's compelling analysis is that this limb of the test:

> … must involve a quantitative assessment of the impact of the transaction on the company's balance sheet, future profits and future cashflow. Since the company's ability to pay creditors must be taken into account, as well as the interests of the company and its shareholders, the quantitative assessment must have regard to the impact of the transaction on assets (balance sheet), future profitability (which affects the interests of shareholders) and future cashflow (which affects ability to pay creditors). In making their assessment on these matters, the directors could well be assisted by the report of an expert in financial analysis, though the issue under s260A does not turn on the directors' or an expert's opinion on material prejudice but on whether the giving of financial assistance was in fact materially prejudicial.[17]

Looking at the plain meaning of the words of the second limb, if the target's guaranteeing of the acquisition debt results in the reduction of the credit standing of the target from, say, comfortably above investment grade to sub-investment grade, as would be common in the case of a leveraged takeover financing, it is difficult to sustain the argument that the company's ability to pay creditors has not been materially prejudiced (even if not fatally wounded).

The meaning of the same expression, 'materially prejudice the company’s ability to pay its creditors', was considered in the case of *Re CSR Ltd* [2010] FCAFC 34, in the context of the share capital reduction provisions, and the joint judgment puts it clearly, as follows (at [45]).

> [T]he text of the [*Corporations Act*] and the explanatory memorandum which accompanied the Bill which introduced s 256B into the Act are not particularly helpful. In cl 12.23 it said: 'Whether prejudice is ‘material’ will be a question of judgment to be determined in light of all relevant circumstances [including the particular characteristics of the company and the situation of the company’s creditors]'. One is, we think, on safe ground, however, in treating 'material prejudice' to a company’s ability to pay its creditors as relating to the creation of a material as opposed to theoretical *increase, in the likelihood* that the reduction in capital will result in a *reduced ability* to pay creditors

To set the bar at the level of destruction of the company's ability to pay its debts would leave no work for the insolvent trading prohibition (s588G and the like). In *CSR*, considering the same language, the judge had no doubt that a materially reduced ability to pay creditors, even if still solvent, would be a problem. So if the financial assistance would materially diminish the target's ability to pay its creditors, then it would be most unwise to rely on the no material prejudice exception.

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15 Yuen-Yee Cho and Vishaal Kishore, 'The 'material prejudice' test and financial assistance' (2004) 78 *Australian Law Journal* 194, 202.

16 *Re HIH Insurance Limited; Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253, 339.

17 Ford H, Austin R and Ramsay I, *Ford's Principles of Corporations Law* (Butterworths Online subscription service) at [24-710], http://www.butterworthsonline.com viewed 8 July 2014.

Onus of proof and the benefit of hindsight

As mentioned, the exception for material prejudice must be affirmatively established by the party seeking to 'save' the transaction. The onus is on the target's directors and financiers (as parties potentially involved in the contravention) to prove that there was no material prejudice.

Giles JA in the Court of Appeal (approving Santow J's first instance approach) stated: 'the substance of s260A(1) is that financial assistance is not to be given unless one of some conditions is satisfied, and it begins with a prohibition which does not apply in the circumstances stated in its paras (a), (b) and (c)'. His Honour said the conditions suggest that the company has the burden of proof because 'it would otherwise be necessary for the plaintiff to exclude a great many matters some of which are known only to the company'. He said also that 'the negative in para (a) suggests the burden is on the company, since the issue is not whether giving the assistance *is* prejudicial to the company, its shareholders or its creditors, but whether giving the assistance is *not* prejudicial to any of them, and the tenor of the provision is that the company can give the financial assistance only if it is satisfied that there will not be prejudice' (New South Wales Court of Appeal in *Adler v ASIC* [2003] NSWCA 131 at [410]). The judgment in *Kinarra Pty Ltd v On Q Group Ltd* [2008] VSC 12 at [44] endorsed this approach and confirmed the operation of the presumption as follows.

> In this case the plaintiffs have to prove a transaction of the kind that leaves open the allegation that by the transaction On Q is financially assisting IPay to acquire shares in On Q. Thus, in this case, if the plaintiffs do so the court must assume that the conduct so proved constitutes or would constitute a contravention of s 260A(1)(a) unless On Q proves otherwise or On Q makes out the defence available in para (a).

Can the issue of material prejudice be considered with the benefit of hindsight? In *ASIC v Adler* Justice Santow looked at the full history and impact of the transactions in assessing material prejudice. In resisting an argument that he should assess material prejudice at the time the financial assistance was given, his Honour stated:

> As I earlier conclude, one assesses material prejudice by reference to the transaction with its interlocking elements giving rise to the financial assistance, taking into account its financial consequences for the interests of the company or its shareholders. This is in order to determine where the net balance of financial advantage lies from the giving of the financial assistance.[18]

Justice Santow went on to consider details of the eventual loss resulting from the financial assistance, noting that such losses were inherent in the financial assistance given. The Court of Appeal confirmed that it was relevant to look at the actual loss subsequently suffered by the HIH group in consequence of the transaction, because the actual loss reflected the potential diminution in the value of the affected group assets.

The issue of whether the financial assistance prohibition applies will, in practice, usually arise when the bank financing the takeover seeks to rely on the guarantee or security given by the target. That is in circumstances where the target has got into financial difficulties or become insolvent. It would be very difficult for a judge to ignore the dramatic consequences of the giving of the guarantee (target insolvency or receivership). Those consequences will surely be regarded as 'inherent in the financial assistance given'.

Banks do not like taking risks with guarantees and third party securities; they know they are fragile. They will normally take all measures available to ensure that they are effective and enforceable. They will be unlikely to accept the invitation put forth by some to conduct appropriate due diligence and 'take a view'.

[18] *Re HIH Insurance Limited; Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253, 339.

Refinancings: does the 'no material prejudice' exception help?

In what circumstances can the bidder use the target's assets to assist it to refinance the acquisition debt (eg by the target giving a guarantee or security for the refinancing)? Can financial assistance given in connection with a past acquisition contravene the section?

Section 260A(2)(a) says the timing, of itself, is not determinative. But in a refinancing scenario financial assistance can hardly assist the acquisition, in an objective sense, unless the postponement is part of a pre-ordained scheme (see *Juniper Pty Ltd* v *Grauson* (1984) 8 ACLR 212). Where the refinancing is not 'premeditated', that is, the directors of neither the bidder nor the target had formed or communicated their intentions in relation to the refinancing , the transaction would seem to be fairly safe. Although it is 'connected' with the past acquisition because it financially assists the bidder to meet an existing commitment incurred for the purposes of that acquisition, mere 'connection' is a creature of the previous prohibition[19], and arguably does not suffice under the current version.

Austin J considered the issue (in an *ex tempore* judgment) in *Law Society v Milios* [1999] NSWSC 1272. The facts before his Honour involved a time separation of some years and the transaction under consideration arose out of events which could not have been contemplated at the time of the acquisition. His Honour said that the 'striking separation in time' meant that it would be surprising if the transaction fell within the prohibition.

Nevertheless, his Honour considered submissions on the degree of connection required. His Honour favoured the view that the new wording did not displace the old case law with respect to the linking of the acquisition and the assistance. So financial assistance can be held to have been made to acquire shares even if the assistance comes some time after completion of the acquisition, 'provided there is a link between the two which draws the transaction within the policy concerns which the section addresses' (at [25]). Those policy concerns were, of course, enunciated by the Greene Committee, which was concerned with a practice whereby a syndicate would acquire a controlling shareholding of a target company by the use of a temporary loan, and on obtaining control replace the board with its nominees and cause the target to lend its liquid funds to the syndicate to enable them to repay the temporary loan; ie the target's own funds were effectively used to finance the acquisition of a controlling interest in it.

So the key question becomes whether there is a 'link' which is consistent with the mischief addressed by the prohibition. The link will exist if the particular financial assistance was in the contemplation of the future controllers of the target at the time of the acquisition, especially if an agreement, arrangement or understanding was in place with the financier or some other relevant party (ie a pre-ordained scheme), or if it can be inferred from the short term or bridging nature of the takeover finance. On the other hand, guarantees and securities given by the target as part of a subsequent (unplanned) general refinancing of the group of which it has become a member should no longer pose a concern under s260A. This would fall within the 'complete severance' which meant that the prohibition did not apply in *Milios*.

Much will depend on the circumstances, and where the guarantee is given shortly after the acquisition, this may suggest that there was a pre-acquisition plan to use the target's resources, and a whitewash would be the prudent course.

[19] Under the old s205, there was a concern that such financial assistance could nevertheless be 'in connection with' the acquisition as the guarantee or security was literally connected (albeit indirectly) with the acquisition, as it assisted repayment of the debt which enabled it. Kirby P in *Darvall v North Sydney Brick & Tile Co* (No 2) (1989) 7 ACLC 659 at 686 suggested that the 'connection' requirement 'allows the court to apply a common sense approach'. In *Milburn v Pivot* (1997) 15 ACLC 1,520 Goldberg J read the connection requirement very much as subsidiary to the purpose test. In *Sterileair Pty Ltd v Papallo* (1998) 29 ACSR 461 the Full Federal Court took a similar, 'commercially realistic' approach to the connection test

In one pertinent case, concerning approval of the scheme of arrangement for Nine Entertainment Group Limited (*In the matter of Nine Entertainment Group Limited (No 1)* [2012] FCA 1464 at [66 & 67]), the judge observed in relation to one of the objections raised by a minority creditor:

> The only other issue which was referred to in the company's submissions was whether the new loan facility which will be used in part to fund the cash payments under the scheme constitutes the provision of financial assistance in contravention of s 260A of the Act. The issue arises because the new facility will be secured against the assets of the Nine Holdings Group.
>
> In my opinion, the short answer to this question is that even if the grant of security does constitute financial assistance, it does not contravene s 260A because any such assistance does not materially prejudice the interests of the company within the meaning of s 260A(1)(a) since the scheme provides the opportunity for all secured creditors (including Red Earth) to consent with full disclosure of the details of the proposed transaction: see *Anzon Australia Limited, in the matter of Anzon Australia Limited* [2007] FCA 2079 at [34] (Lindgren J).

With respect (the point may not have been argued in detail), it does seem curious to relate the interests of the company to those of the secured creditors, ignoring the shareholders and unsecured creditors, not to mention the minority secured creditors who were objecting, but in the end it would have been in the judge's contemplation that the whole purpose of the scheme and its related financing was to save the Nine Entertainment Group from insolvency and puts its finances back on a stable footing, so there was no material prejudice on those fronts either, and this was clearly the right decision. Between *Nine* and *Anzon*, not to mention *Rural Press* (below), you could argue that there is a special rule for schemes of arrangement, which is that anything goes as long as there is disclosure and an opportunity to vote.

One final observation on this aspect is that in the case of the refinancing of an acquisition facility in respect of which financial assistance was approved under s260B the link with the 'mischief' is broken by the whitewash, but there is also a fall-back argument that if there is no increase in the debt, and it is not on more onerous terms, there can be no material prejudice.

The curious case of dividends

One of the principal purposes of the 1998 reform of the financial assistance prohibition was to simplify and streamline the drafting. Much was omitted, including the definition of 'financial assistance'. Yet one thing the legislature kept was the curiously equivocal statement in s260A(2)(b) that financial assistance 'may take the form of paying a dividend'. Surely the payment of dividends is already well enough regulated, as a fundamental exception to the maintenance of capital rules?

Say the target has undervalued assets and liquid funds or the ability to raise funds quickly and easily. Can the takeover financier, in its facility agreement with the bidder, require the bidder, on gaining control, to 'create' a distributable profit by, for example, selling or revaluing (and mortgaging) the assets and then to distribute the cash by way of dividend (known as a 'nimble' dividend) for application in reduction of the facility? This does seem to be within the mischief the Greene Committee sought to address, and so the answer, as is common, is that it all depends.

In the previous formulation of the prohibition, section 205(8)(a) provided an exemption for the payment of a dividend 'in good faith and in the ordinary course of commercial dealing'. This reflected an intention that the prohibition should not preclude the 'proper' declaration of profits (specifically approved in the context of assisting repayment of acquisition finance in the Jenkins Committee's 1962 report). But equally the exception did indicate that dividends which are not declared in 'good faith and in the ordinary course of commercial dealing' may be suspect. Surely, if any, the 'nimble' dividend fell in the latter category. It is suggested that the use of 'may' in section 260A(2) points in the same direction, particularly as the explanatory memorandum indicated an intention to relax, not tighten the law. The following cases on the old law, then, are likely to inform consideration of the application of the current prohibition to dividends.

In *Re Wellington Publishing Co. Ltd*. [1973] 1 NZLR 133 Quilliam J. held that a large dividend to be declared and paid to a bidder after a successful acquisition would not constitute financial assistance and accordingly would not contravene the New Zealand prohibition. But that case cannot be taken too far because:

- the dividend was 'properly' declared out of revenue reserves
- although the dividend was to be funded largely by the raising of a loan, there would still be a large surplus of assets over liabilities in the company - the payment of the dividend would not jeopardise the solvency of the company or prejudice its creditors
- there were no minority shareholders
- Quilliam J. was only prepared to hold that the payment of a dividend would not ordinarily breach the section

Rossfield Group Operations Pty Ltd v Austral Group Ltd (1980) 5 ACLR 290 related to a friendly takeover in which the bid vehicle would rely on an unusually high flow of dividends from the target in order to service and repay the debt incurred in acquiring the target. The boards of the target and the bid vehicle were well aware of this. The target also met the costs of the formation of the bid vehicle. An action was brought by minority shareholders in the target, alleging financial assistance. It failed.

Connolly J had 'great difficulty in regarding the declaration of a dividend as the giving of financial assistance...Giving financial assistance...means making a provision in money or money's worth to which the shareholder is not already entitled in his capacity of a shareholder' (at 296).

Again the dividends were to be paid out of revenue reserves, and it was acknowledged by the chairmen of the boards of both companies that neither the asset revaluation reserve nor the share premium reserve ought to be used for this purpose (at 297). In addition, the target was in a buoyant trading position so presumably the creditors were not prejudiced.

What is possible under the current laws relating to dividends?

Unrealised accretions to the value of a company’s capital assets may be available for dividend where it is clear that the accretion in value is of a permanent character - see *QBE Insurance Group Limited v Australian Securities Commission* (1992) 38 FCR 270 at 288. And it has been held to be legitimate for a company to calculate its profits, for the purposes of paying a dividend, by revaluing the company’s assets and recognising in the company’s accounts any profit thrown up by the revaluation (see *Dimbula Valley (Ceylon) Tea Co Limited v Laurie* [1961] Ch 353; *Industrial Equity Limited v Blackburn* [1977] HCA 59; (1977) 137 CLR 567; *Marra Developments Limited v BW Rofe Pty Limited* [1977] 2 NSWLR 616 at 630).

On the other hand it is the author's understanding that current accounting standards no longer recognise as a profit an unrealised upward asset revaluation (unless reversing a previous devaluation). Although the courts have traditionally only regarded accounting principles as influential, directors and auditors are bound to follow approved accounting standards: s296 (unless they are inconsistent with the law: s338). It would be a brave director who declared a dividend out of something which could not be shown as a profit in the accounts.

At the risk of getting side-tracked, the statutory regulation of dividends is itself in flux[20]. On 28 June 2010 the traditional rule that dividends may only be paid out of profits was replaced with a new version of s254T to the effect that a company may not pay a dividend to its shareholders unless:

1 the company’s assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend;

20 See: 'The payment of dividends: Legal confusion, complexities and the need for comprehensive reform in Australia', Stephen Alevras and Jean du Plessis (2014) 32 *Company & Securities Law Journal* 312.

2 the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and

3 the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

This change caught many of us by surprise, and caused both confusion and concern, exacerbated when the Australian Taxation Office ruled that the three prohibitions quoted above in the new s254T had not displaced an inherent requirement that a dividend can only be paid out of profits[21]. So under the current law one would expect that, to the extent dividends are regulated by the financial assistance prohibition, it should not be difficult to satisfy the 'no material prejudice' test where the new, onerous requirements for paying the dividend are satisfied.

Protest at the impracticality and vagueness of the 'toxic' new regime ensued, and a number of draft amendments have been tabled. Under the most recent draft version of s254T (issued on 10 April 2014, in the exposure draft of the *Corporations Legislation Amendment (Deregulatory and Other Measures) Bill* 2014) the whole test will be replaced with a simple solvency test:

> …immediately before the dividend is declared/paid, the directors of the company reasonably believe that the company will, immediately after the dividend is declared/paid, be solvent

This suggests we would be back to the inherent general law 'profits' test, with all its familiar uncertainties. But the draft Bill also expressly exempts dividends on ordinary shares from the capital maintenance provisions to the extent they are equal reductions in capital, which is helpful but implies dividends can be paid otherwise from profits (as do some related reporting changes).

Finally, on this aspect, regardless of which formulation of s254T prevails, it is suggested that dividends are inevitably more susceptible to qualifying under the no material prejudice test than other forms of assistance. In *Rural Press Ltd, in the matter of Rural Press Limited* [2007] FCA 314 at [26 & 27], another scheme of arrangement case, the judge found, in relation to some unusually large special dividends, as follows.

> By reason of payment of the Special Dividends, Rural Press is giving assistance to Fairfax to acquire shares in Rural Press. The Board of Rural Press has determined that the giving of this financial assistance is in the best interests of its shareholders and of Rural Press itself, and will not materially prejudice its ability to pay its creditors. Disclosure of this matter and of the determination by the Board of Rural Press is also set out in the Scheme Booklet.
>
> The assistance is not prejudicial to the interests of Rural Press or its members because the recipients of the Special Dividends are the members of Rural Press. Moreover, they are given the opportunity to vote on the proposed Schemes after that full disclosure. Nor is the assistance prejudicial to Rural Press's ability to pay its creditors. After payment of the Special Dividends (to be funded from existing borrowing facilities), the net assets of Rural Press will still be approximately $410 million, and although its borrowings will increase to approximately $342 million, Rural Press will be able to meet its financial commitments in the ordinary course, and Fairfax has undertaken to repay Rural Press's borrowings that are required to be repaid on the Implementation Date.

This observation, while open to challenge on the reasoning (there is no consideration of the arguments canvassed above), shows that the 'no material prejudice' test can most likely be relied on to support larger than normal dividends so long as they are paid equally to all shareholders and the company remains robustly solvent.

21 *Ibid* at 315.

The alternative: shareholder approval

The principal alternative route around the financial assistance prohibition is shareholder approval under s 260B, the 'whitewash'. It is a strikingly anomalous exception given that, unlike the other capital maintenance rules in Chapter 2J, shareholders can, in effect, waive material prejudice to creditors. The creditors in turn cannot object to material prejudice if the shareholders approve, unless the financial assistance would result in insolvency.[22] Indeed, unless creditors subscribe to the ASIC Alert service, they will not even become aware of the proposed whitewash, as there is no requirement for the proposed financial assistance to be advertised.

Except in the rare case (especially for highly leveraged transactions) that the target becomes a subsidiary of a listed entity or is left with minority shareholders, the shareholder approval procedure is so simple and effective that it prompts the question, why did the legislature bother requiring it?

There are in theory two options for shareholder approval under s260B(1), but because interested parties (ie the bidder and its associates) cannot vote on a special resolution under paragraph (a), the first option will not be available, and normally approval of all ordinary shareholders in general meeting (or, in the case of a proprietary company, by circulating resolution: s249A or s249B[23]) will be required under s260B(1)(b). Needless to say if there are minority shareholders the 'whitewash' option will not realistically be available. So to be sure of being able to get access to the target's assets and cashflow, takeover financiers will want their bidders to have a condition which requires the bid to reach the compulsory acquisition threshold of 90%, so that the bidder will be able to mop up the minorities.

One other wrinkle is the requirement under s260B(2) that the ultimate domestic listed holding company after (rather than before) the acquisition must also approve the financial assistance, by special resolution passed at a general meeting. Directors of listed companies do not enjoy holding general meetings!

For completeness, under s260B(3) the shareholders of any unlisted ultimate Australian holding company must also approve, by special resolution.

The formal waiting period is 14 days assuming waiver of notice of the general meeting[s] of shareholders. But Australian listed companies must give 28 days notice of a general meeting, and members cannot waive this: s249HA. ASIC must be notified before dispatch of material information to members; and the company must wait 14 days after the resolution is passed (and notify ASIC of approval).

Care must be taken with notices: they must set out all material information known to the company, and *Milburn v Pivot* (1997) 15 ACLC 1,520 suggests quite a strict standard will be imposed.

So unless the bidder is a listed company, or there are minority shareholders, the whitewash process is fast (with appropriate consents to short notice, it can be completed in little more than 14 days), it is discreet (there is no longer a requirement to place advertisements in the newspapers) and it is certain (there is no procedure for creditors to object, absent insolvency).[24] It is also convenient. But the

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22 By operation of s588G of the *Corporations Act 2001* (Cth).

23 The amendment to the *Acts Interpretation Act* 1901 (Cth) that took effect on 27 December 2011 to include headings in the interpretation of Acts may affect the application of sections 249A and 249B where a single member company proposes to obtain shareholder approval under s260B. Section 249A is entitled *Circulating resolutions of proprietary companies **with more than 1 member*** [emphasis added]. The *Acts Interpretation Act* may leave open an argument that s249A is not available to a single member company - because of the words to that effect in the heading. Although a single member company can pass a resolution under section 249B, s260B(1)(b) requires member approval 'at a general meeting', and s 249B would not have the benefit of the deeming under s249A(6) that a resolution obtained this way suffices for a general meeting. In my view it cannot have been Parliament's intention to make it impossible for a single member company to avail itself of s260B, so a judge will be free to ignore the limiting words in the heading of s249A.

24 The suggestion to the contrary in Keith Fletcher, 'Re-Baiting the Financial Assistance Trap' (2000) 11 *Australian Journal of Corporate Law* 119, 133-136 is clearly wrong, for the reasons set out in Michelle Welsh, 'The Corporations Act Financial Assistance Provisions Offer Limited Assistance to Creditors' (2003) 17(1) *Commercial Law Quarterly* 3, 5-6.

whitewash procedure is cumbersome, expensive and time consuming where the bidder is a listed company, and it cannot be used if there are dissentient minority shareholders.

Practical steps: the effective date mechanism

In practice financiers are usually comfortable relying on a condition subsequent, and being unsecured as against the target for a fortnight or so from financial close. Because it can be difficult to get things done after financial close, the preferred approach is to have the shareholders resolutions passed and notices lodged with ASIC at or before closing and to take the target group security and/or guarantees at closing. The guarantees and security would include an overriding condition to the effect that the security or guarantee will not secure the acquisition financing until expiry of the waiting period – this way the security will automatically spring into effect. And meantime the target group security/guarantees can secure other non-acquisition related debt, such as working capital and capex facilities.

This is not so easy with listed bidders but given they have more substance than the more commonly used special purpose bid vehicles, and lower overall gearing, financiers will often agree to defer the financial assistance whitewash until the next general meeting of the listed company, if that is not likely to be too long delayed.

The risks of 'taking a view': involvement in contravention

What are the risks of 'taking a view' on material prejudice? Financiers, and, indeed, directors and officers, should not take much comfort from s260D(1) which says that a transaction in breach of the prohibition is not invalid. The purpose of that provision is to protect the target, to ensure that the company giving the financial assistance does not suffer.

Any person ‘involved’ in a company’s contravention of section 260A contravenes a civil penalty provision (section 260D(2)). Section 79 defines when a person is ‘involved in a contravention’ and includes any person who has ‘aided’, ‘abetted’, ‘induced’ or been ‘knowingly concerned in’ the contravention. There is also every likelihood that a person knowingly concerned in a contravention could be ordered to compensate the company. To be knowingly concerned, you need not know it is a contravention, you simply need to be aware of the essential facts giving rise to the contravention (*Georgianni* v *R* (1985) 156 CLR 473). The essential facts are that a company has given financial assistance for the acquisition of shares in itself. Because the no material prejudice provision is a defence, it is not an essential ingredient[25] and any financier will have sufficient involvement and knowledge to be exposed to accessory liability.

Any benefit the financier obtains from the contravention, in particular recoveries under a guarantee or security given by the target contravening the section, may be liable to be repaid to the target by way of damages or compensation under ss1317H or 1324 in proceedings by the target's liquidator, ASIC or other affected persons. In other words, although the validity of the transaction might be preserved under s260D, the value, to the financier involved in the transaction, of the guarantee or security given in breach will effectively be nullified. And if the involvement is found to be 'dishonest', this is an offence under the *Corporations Act*.

Faced with these genuine risks (not to mention the reputational risk of contravening the *Corporations Act*), a prudent financier will not 'take a view', but will insist on the swift and simple shareholder whitewash procedure available under s260B.

[25] See *Re HIH Insurance Limited; Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253, 343.

Reform

Given the ease of the shareholder whitewash process, and its illogicality (why should shareholders be able to waive material prejudice to creditors?), the problems with interpreting material prejudice as a test, and the extensive legal protections that cover much the same ground, notably directors duties, the insolvent trading liability regime and relief from oppression, there is a good case to be made that the financial assistance prohibition has outlived its usefulness.[26] It is no more than red tape and should be abolished.

If we are set on retention of the prohibition, this could only logically be out of concern for the position of minority shareholders, so there are still two reforms that should be implemented:

1 adding equal dividends on ordinary shares into the list of exceptions in s 260C(5); and

2 adding an exception for the case where the target becomes a wholly owned subsidiary of the bidder.

These are both common sense reforms. These exceptions would significantly decrease the headaches the prohibition causes for financiers, without compromising its efficacy to prevent objectionable transactions. The second reform would be entirely consistent with the thrust of s187 of the *Corporations Act*, which allows directors of a wholly-owned subsidiary to act in the best interests of its holding companies.

Conclusion

There is a strong case for the abolition of the financial assistance prohibition. The introduction of the 'no material prejudice' defence has proven to be an unsatisfactory half measure. Difficult questions of degree always arise when considering necessarily vague concepts like 'material prejudice'. That is the curse of this unwelcome accretion to the field of 'adjectival jurisprudence'[27] – it will always be hard to predict a judge's decision in any particular case. The complexity of the prohibition's interpretation is absurd when a breach can be avoided the simple and effective procedure of shareholder ratification where the company becomes a wholly-owned subsidiary. Even more absurd is the requirement that a listed holding company must also have a shareholders meeting, which serves no intelligible purpose. The prohibition is nothing but problematic when creditors and minority shareholders can be sufficiently protected by directors' duties and the sanctions associated with insolvent trading and oppression.

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26 For a comprehensive case for the abolition of the prohibition see Kate Wellington 'Regulating financial assistance: an obsolete regime' (2008) 26 *Company and Securities Law Journal* 7. In the UK the prohibition ceased to apply to private companies in 2008.

27 Mr Justice J.E.J. Spender, during Questions and Answers following his paper 'Unconscionability and Section 52 of the Trade Practices Act in Banking Transactions', at the 1989 6th Annual Conference of the Banking Law Association, page 36.