# REVERSE TAKEOVERS: ASX ENTERS THE FRAY

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Legal Briefings

The ASX has entered the reverse takeover debate with the release of a Consultation Paper on whether bidders should obtain shareholder approval when participating in scrip takeovers or schemes.

## SUMMARY


- The ASX has released a Consultation Paper on whether bidders in scrip takeovers and schemes ought to obtain shareholder approval.
- This follows complaints from proxy advisers and shareholder activists that the current rules do not allow shareholders enough say in these deals.
- If any change was made, ASX's consultation proposal is that a bidder would need to seek shareholder approval if the issue of new securities exceeded 100% of the bidder's share capital.
- The status quo of no shareholder approval should be preserved for reasons including the significant costs of these approvals, coupled with the small number of times this has ever been an issue as well as the overview the Takeovers Panel provides in situations where control issues are at play.


## OVERVIEW

Earlier this month, the ASX, by its release of a Consultation Paper, entered the debate on one of the governance industry's current *causes célèbres*, the reverse takeover.

The issue, in general terms, is that neither the Corporations Act nor the ASX Listing Rules require a vote of a bidder's shareholders in a listed company takeover or scheme where the bidder is smaller than the target.

The ASX is calling for submissions by 17 December 2015 on whether or not to maintain the status quo or to require that a bidder's shareholders approve a scrip deal, with that approval threshold being set by reference to either the level of dilution or of the impact on control.

While acknowledging the case for the status quo, ASX also put forward a consultation proposal if there was a desire to change the regulatory settings. That proposal was that a bidder would need to seek shareholder approval if the issue of new securities exceeded 100% of the bidder's share capital.

## A WORD OF CAUTION: REVERSE TAKEOVERS, DILUTION AND CONTROL

Before examining the relevant matters, it is important to note that the term 'reverse takeover' is used broadly, including where the issue at hand is merely one of dilution (that is, a bidder simply issuing many shares) as opposed to control (that is, a bidder issuing shares with the result that a particular target shareholder gains a controlling stake in the bidder post-merger).

In the great majority of cases, reverse takeovers are in fact merely situations involving questions of dilution as opposed to control.

## THE BACKGROUND: GLOUCESTER COAL AND ROC OIL

The chorus of proxy adviser complaint around reverse takeovers had its genesis in two proposed transactions: the Gloucester Coal – Whitehaven merger of 2009 and the Roc Oil – Horizon Oil merger of 2014.

In each of those proposed deals, the bidder – Gloucester Coal and Roc Oil respectively – was smaller than the target.

The Gloucester Coal context was an interesting one. Noble Group, Gloucester's 21.7% major shareholder, had informed the Gloucester Coal board that it intended to exert control over Gloucester by creeping up the register, but that it did not wish to make a takeover bid. Gloucester then proposed a scrip merger with Whitehaven by way of a takeover bid.

Noble in turn launched a cash takeover bid for Gloucester, at $4.85 per share. Noble also applied to the Takeovers Panel. Noble alleged that a number of Whitehaven's shareholders were associates and that between them, those associates would control 51% of the merged entity. Noble applied for orders that a vote of Gloucester's shareholders be held to decide whether the merger with Whitehaven would proceed, with voting exclusions that would have guaranteed that the vote would have been defeated.

The initial Panel made those orders, but the decision was reversed by the Review Panel who appreciated that the commercial effect of the initial Panel's orders was to ensure that there would be no Whitehaven merger and no prospect of Gloucester getting a higher bid than the $4.85 on offer from Noble. The Review Panel put its faith in the Gloucester board and ordered that the board could choose the deal it preferred.

The ensuing competitive tension meant that Noble eventually increased its bid to $7.00 per share to secure the board's recommendation, with the consequence that the merger with Whitehaven did not go ahead. The Review Panel did not agree that the relevant Whitehaven shareholders were associates, and thus did not consider that there were control issues at play.

Roc Oil was also an interesting deal. There, a proposed merger between Roc Oil and Horizon Oil was planned by way of a scheme of arrangement, though Roc Oil had maintained the contractual ability to terminate that deal if a superior proposal for Roc Oil emerged. Allan Gray, an activist investor who held or was the investment manager for 19% of the Roc Oil register, led the campaign for a Roc Oil shareholder vote to consider the deal given that a merger for growth, consistent with Roc Oil's stated strategy, was contrary to its aims of cash returns from the business.

A shareholders' meeting was ultimately requisitioned by Allan Gray to seek to change the constitution of Roc Oil to prevent it from issuing securities in excess of 30% of its existing capital without a shareholder vote. There were no exceptions to the proposed restriction, such as for a pro rata rights issue. The resolution, which required a 75% vote, failed, despite a wide ranging campaign.

As it turned out, a superior cash takeover bid for Roc Oil was made by Fosun and the Horizon Oil deal was terminated.

## THE GOVERNANCE DEBATE AND THE ROLE OF THE PROXY ADVISERS

It is natural that a proxy adviser whose lifeblood is writing reports on how to vote at meetings would, unsurprisingly, wish to have more meetings.

And so it is that some Australian proxy advisers have sought to impose hurdles on the ability of boards to issue scrip that dilutes existing shareholders. They consider reverse takeovers a stain on the regulatory landscape, in much the same way as certain interest groups sought to abolish mergers by way of scheme of arrangement in the early years of this century.

The ironic consequence of this position is illustrated by the Roc Oil deal. In that deal, there was advice from a proxy adviser to the effect that while the independent expert recommended the Roc Oil – Horizon Oil merger, and while voting in favour of the Allan Gray resolution would have ended that merger, Roc Oil shareholders should still have supported the resolution changing the constitution because it would have given those shareholders a say on the merits of scrip mergers.

In other words, pared to its essence, this was a recommendation to destroy value on the basis of a broader philosophical position on governance.

It is also worth noting that international comparisons are often used to justify the argument that tighter regulation in this area is needed and that shareholders need to be protected against dilution from scrip bids. While those comparisons are interesting, there is always some danger in cherry-picking a single aspect of one regulatory regime, while ignoring the rest of the regulatory landscape under that regime.

## IF IT AIN'T BROKE DON'T FIX IT – REASONS TO PRESERVE THE STATUS QUO

Any regulatory change needs to be made for good reason, and the costs of that change need to be worthwhile.

Here, the case for change has not been made:

- *There is no real problem to "fix":* Scrip based deals where the bidder is smaller than the target are an unremarkable feature of Australian corporate life. Transactions may need to be structured that way for a number of reasons. There have been at over 40 such deals in the last 15 years. There are only two instances where there has been any real controversy, and each of those involved a major shareholder who wanted to block a transaction, which may have been beneficial to other shareholders, for its own particular individual reasons.

- *Policy of an efficient and competitive market:* In circumstances where there are competing policy considerations, regulators should hasten slowly before giving individual shareholders an increased ability to block deals. Shareholder activists and proxy advisers by definition may wish to do exactly that. But a balance must be struck and responsible boards must be given sufficient scope to execute deals that benefit the majority of shareholders without costly and unnecessary hurdles being placed in the way.

- *Costs are significant:* In terms of costs, the additional cost of these reforms, not just in detracting from a competitive market for control as described above, but also just in terms of the time and cost of convening meetings, should be acknowledged.

- *Control issues are dealt with by the Takeovers Panel anyway:* As mentioned above, the "reverse takeover" debate is one of dilution and separately, of control. It is important to note that the control elements of the debate are regulated by the Takeovers Panel (and ASIC), and so the issue on the table is simply dilution.

- *Shareholders are able to call a vote now if they want:* And last but not least, as the Roc Oil transaction demonstrated, shareholders can call a vote anyway, even without any regulatory reform. So rather than legislate that every reverse takeover, or a class of them, needs bidder shareholder approval, why not just leave it to the odd deal where a major shareholder wishes to take issue?

## NEXT STEPS

As mentioned above, ASX has asked for submissions by 17 December 2015, presumably with the results of that consultation emerging in the new year.

This article was written by Tony Damian, Partner, Sydney. Tony acted for Roc Oil and for Gloucester Coal on the two proposed mergers cited in the ASX Consultation Paper.

The views expressed in this article are the author's own and do not necessarily represent the views of Herbert Smith Freehills or its clients.

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