HERBERT SMITH FREEHILLS

SHOULD COMPANIES WORTH LESS THAN $10 MILLION BE EXEMPT FROM TAKEOVERS LAWS?

28 June 2017 | Australia
Legal Briefings – By **Rodd Levy** and **Kam Jamshidi**

The cost of compliance with Australia's takeovers law can discourage small company acquisitions, contributing to an inefficient market for company control and placing an undue burden on regulators. In this article, we consider whether it is time to introduce an exemption from the takeovers law for companies with a market capitalisation below $10 million.

IN BRIEF

- The cost of compliance with Australia's takeovers law can discourage small company acquisitions, often deterring transactions that would otherwise allocate assets to those who can use them most efficiently.
- We discuss the idea of an exemption from our takeovers law for companies with an equity value less than $10 million.
- Such an exemption would allow for a better allocation of resources, encourage share trading (delivering higher share prices for shareholders) and reduce regulatory costs.

BACKGROUND

Company takeovers are an essential part of the Australian economy. They enable companies to be controlled by those able to extract the highest value and therefore willing to pay the highest price for them. This promotes economic growth, which is critical in a low-growth environment.

Our takeovers law seeks to promote efficiency in the market for corporate control while still protecting the interests of shareholders.

However, in the context of small companies, the cost of protecting shareholders' interests under the law is too high. It discourages small company acquisitions and creates an inefficient market where assets are not readily available for those willing to pay the highest price.

We believe that that companies with an equity value below $10 million should be exempt from our takeovers law. Potential acquirers should be free to get on with proposals without having to worry about the regulatory red tape.

To create certainty, the value would be tested at a point in time, say 30 June or the date of release of the company’s accounts, and would be effective for the next 12 months, when it would be tested again. If necessary, the exemption could be lifted automatically if there was issue of further shares over a certain amount (say, 15%) and the company’s equity value increased over the $10 million threshold.

THE CASE FOR AN EXEMPTION

On our analysis, 520 of the 1778 companies listed on the ASX (or 29 per cent) have a market capitalisation of less than $10 million. Yet only five of the 40 (or 13 per cent) takeover proposals so far this financial year have involved companies with a market capitalisation of less than $10 million. They should have the highest representation.

One major contributing reason for this anomaly is the relatively high direct costs of compliance with the takeovers law. In a small company takeover, compliance costs of 10 per cent or more of the value of the company are not unexpected. This cost deters transactions that would otherwise deliver significant benefits to the acquirer and target shareholders.

Another factor is the inability for a bidder to strike a deal over more than 20 per cent of the shares without first making a bid and the uncertainty that creates. That is an indirect cost of the present rules.

In addition, ASIC and the Takeovers Panel are required to devote significant resources to small company takeovers, all of which would be freed up if the law ceased to apply.

To give an indication, of the 17 matters brought before the Takeovers Panel since July last year, almost half related to target companies with a market capitalisation of less than $10 million. All the costs involved in adjudicating these matters would be saved if the rules did not apply to them.

These problems will only get worse as more and more start-up companies seek crowd-funding and reach 50 shareholders. That will create a whole new group of small companies subject to the takeovers law.

EXEMPTION TO BUILD ON CURRENT POLICY WHILE STILL PROTECTING SHAREHOLDER INTERESTS

We consider that the exemption of small companies from Australia’s takeovers law would have only a marginal impact on shareholders' interests.

An exemption should encourage more trading in small company shares, and any bidder wishing to reach 100 per cent ownership via compulsory acquisition (which should be the majority of bidders) would still need to ensure that the holders of 90 per cent of shares are supportive. Shareholders would still have the benefit of laws protecting minority shareholders.

The reform we propose builds on the current policy which is to exclude small companies due to regulatory cost. However, the current rule only exempts non-listed companies with less than 50 shareholders from the law. We think a headcount test is unsophisticated. Equity value is a much more appropriate measure of what sort of entity should be exempt from the law.

ACROSS THE TASMAN

New Zealand is already ahead of us in adopting a value approach to exclude small companies. They exempt unlisted companies with NZ$20 million or less in total assets. The board is able to decide this and, unless shareholders with 5 per cent or more object, no further shareholder vote is required.

If necessary, a similar opt-out process could be adopted in Australia so that shareholders could decide at the annual general meeting on whether the protections in the takeovers law were actually in their best interests.

CONCLUSION

In conclusion, exempting acquisitions of small companies from the takeovers law should promote better allocation of resources, encourage share trading and reduce regulatory cost.

This article was previously published in the Australian Financial Review.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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