The takeovers debate and accountability

There has been a lull recently in the long-running debate about takeovers regulation. BRUCE DYER believes that the takeovers debate, and the mandatory bid rule, need a fresh airing.

Despite all the ink spilt recently on corporate governance reform, one issue has received little attention. I refer to the role of takeovers in promoting accountability of the management/boards of listed entities.

Reform proposals intended to increase the effectiveness of takeovers in that role through the introduction of a mandatory bid rule (MBR) were shelved just before the current spate of corporate collapses. They were derailed by a long and polarised debate among specialist takeover practitioners and commentators about the fundamental policy goals of takeovers regulation.

The takeovers debate

Two perspectives can be contrasted to set the scene. One is the pro-takeover school. This approach emphasises the benefits of takeovers, usually drawing on economic theory. It points to the fact that the Australian regime restricts takeovers more than most, and prevents bidders seeking any assurance of success before risking a public bid.

The second approach is the shareholder-protection school. This focuses on maximising the price target shareholders receive if a takeover bid is made by requiring a ‘public auction’.

Takeovers and accountability

The pro-takeover school emphasises the benefit of takeovers in promoting accountability of listed entity management. Regime change through takeovers of mismanaged companies may sometimes avert more painful outcomes. Moreover, the threat of takeover can provide a strong incentive for management to address problems. A takeover may bring some social dislocation, such as job losses as a result of rationalisation and other so-called synergies, but generally not on the scale of a major corporate collapse (which might otherwise be the long-term outcome in some cases).

Takeover threat operates quite differently from other accountability mechanisms, in that its effectiveness does not depend on regulators taking action, and should not be undermined if regulators are inadequately funded or staffed.

It comes with an in-built self-adjusting feature that should make it loom largest where it is most needed. Broadly, the threat increases in proportion to the extent to which the incumbent management is not dealing effectively with money invested by shareholders. Unlike mechanisms that rely on approval or action by the general meeting – such as the replacement of an under-performing board – it should not be so vulnerable to shareholder apathy or confusion.

Small shareholders with little incentive to fill out a proxy form will usually have a much stronger motivation to accept a bid offering a decent premium. Finally, the threat of

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Pro-takeover school

- Emphasises benefits of takeovers, including accountability through takeover threat;
- Supports MBR to reduce effect of mandatory public auction undermining takeover threat;

Shareholder-protection school

- Focuses on maximising price for target shareholders through a mandatory public auction;
- Opposes MBR – concerned it will lead to lower prices for target shareholders.
takeover motivates directors and senior executives alike, as a change of control threatens the positions of all. These benefits are sometimes described as the product of a ‘market for corporate control’, which facilitates the allocation of resources to their most productive use and therefore provides incentive for management to maximise the efficiency of their use of shareholders’ funds.

The mandatory bid rule

The benefits of takeovers in promoting accountability were emphasised by the pro-takeover school in 1999, when the MBR was proposed as part of the original "CLERP" reforms. Its supporters argued the MBR was necessary to reduce the impediment for bidders created by both the uncertainty of outcome and reputation risks, which were inherent in making a bid.

Currently bidders cannot obtain any assurance of acceptance above the 20% bid threshold. This exposes them to a public auction in which a bidder risks paying too much to win, or suffering significant reputational and other costs if it loses. The MBR would have allowed a bidder, subject to certain conditions, to exceed 20% (and possibly be assured of success), provided it immediately made a full unconditional cash bid. The shareholder-protection school opposed the MBR, concerned that it would lead to lower prices being paid for targets, since a public auction would be avoided. The MBR was referred to a Parliamentary Joint Committee, where opposition members argued against it, noting ASICs ambivalence and divergent views as to its desirability.

A modified MBR proposal was put forward by the Securities Institute at the end of 2002. This modified MBR proposed the removal of inflexible restrictions on the original MBR, permitting its use for scrip-only bids and conditional bids (provided any conditions were satisfied before the pre-bid agreement became effective). The Institute pointed out that the restrictions affecting the original MBR meant that it could not have been used in most of the takeovers announced since 1999.

The Institute also proposed that, if a major shareholder had not conducted a pre-bid auction process before entering into the pre-bid that triggered the mandatory bid, the shareholder should be able to insist on a condition permitting it to accept a higher counter bid. In effect this would preserve the possibility of a post-announcement public auction unless there had already been a private auction.

Recent developments and the need for the MBR

Significant changes in takeover practice since 1999 have done little to promote the unsolicited bids which fuel the accountability effects of takeovers. Key developments have included the Takeovers Panel being given exclusive jurisdiction to resolve bid period disputes, and the rise and rise of break fee agreements.

As to the first of these – there are differing views as to whether the Panel has made unsolicited bids any easier. As to the second development, some have suggested that break fee agreements – whereby a target agrees to reimburse a bidder’s costs if its bid fails in certain circumstances – may have reduced the need for the MBR. Clearly, break fees can assist bidders by providing limited compensation for the risks of making a bid. However, break fees are within the discretion of target directors (putting to one side rare cases of major shareholder break fees). It follows that break fees do nothing to assist the unsolicited bids required to motivate poorly performing management.

Opponents of the MBR claim that some recent bids illustrate the danger that controlling shareholders may accept too little for their stakes to the disadvantage of the minority. It has been suggested that, had the MBR been available in 2000, Malaysian Mining Corporation (MMC) would have sold all its 49.9% stake in Ashton Mining to De Beers at the $1.62 price fixed under its 19.9% pre-bid, thereby precluding the auction (started by MMC giving another 19.9% pre-bid to Rio Tinto) which led to Rio Tinto paying $2.20 per share.

It is dangerous to speculate what might have occurred in other circumstances. One might expect MMC to have conducted a private auction before committing its entire stake. One might also expect a rational bidder to discount the price offered for a 19.9% stake so as to leave some firepower to answer a competing bid, or to satisfy shareholder expectations of a bid increase.

No doubt a public auction can achieve a higher price if there is more than one bidder – the reputation costs at stake may well cause bidders to pay more than in a private sale. But that may in itself discourage potential bidders and, to that extent, undermine the accountability effect of takeovers.

One notable development in recent years has been the increasing use of schemes of arrangement to effect takeovers. Schemes offer a number of attractions, including a threshold for compulsory acquisition which will usually be easier to satisfy, the prospect of an ‘all or nothing’ outcome within a predictable timeframe and, arguably, less leverage for minorities to extract a price increase.

The introduction of an MBR might well help to make takeovers more attractive and reverse this trend. That ought to please institutional shareholders, who have criticised the growing use of schemes. It may also serve to increase accountability, given that schemes need to be proposed (and therefore supported) by the target.

The current drive to increase the accountability of corporate management makes reconsideration of the MBR timely. It will be interesting to see whether the events of the last few years, and the resulting public concern, have changed the attitude of the MBR’s opponents.

The Institute is currently consulting with the Government regarding a package of takeovers reforms, including a proposal for a Pre-bid Commitment Rule (PCR) which seeks to increase the accountability effect of takeovers.

The views expressed in this article are not necessarily those of Blake Dawson Waldron. The author wishes to thank Byron Köster, George Durbridge, Damian Reichel and David Williamson for their helpful comments.