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Associates and Acquisitions

The Takeovers Code is concerned with transactions that cause a person to become the holder or controller of an increased percentage of voting rights in a Code company. The Code would be ineffectual if it concentrated only on voting rights held or controlled by a particular company or individual. The Code includes the concept of "association" so that when two or more associated parties acquire ownership of, or control of, voting rights above 20% in a Code company the fundamental rule is triggered. It is an anti-avoidance mechanism.

KEY RULES OF THE CODE RELATING TO ASSOCIATION

The key rules of the Code relevant to association are rule 4 (association) and rule 6 (the fundamental rule).

Rule 6(1)(a) provides that a person may not *become* the holder or controller of an increased percentage of voting rights in a code company other than by using one of the exceptions in rule 7 unless, *after that event* that person and *that person's associates* hold or control in total not more than 20% of the voting rights in the code company.

The relevant person has to *become* the holder or controller of an increased percentage of voting rights in a code company before rule 6(1) is triggered. The most common method by which a person becomes the holder or controller of voting rights is an acquisition of shares. However, there are other methods which do not involve an acquisition transaction, such as an agreement where a code company shareholder gives another person control over its voting rights.

"Associate" is defined in rule 4(1) of the Code. Under rule 4(1) one shareholder ("A") will be an associate of another shareholder ("B") if:

- A and B act jointly or in concert; or
- A acts, or is accustomed to act, in accordance with the wishes of B; or
- A and B are related companies; or
- A and B have a business relationship, personal relationship, or an ownership relationship such that they should, *under the circumstances,* be regarded as associates; or
- A is an associate of a third person who is an associate of B and the nature of the relationships between A, the third person and B (or any of them) is such that, *under the circumstances,* shareholder A should be regarded as an associate of shareholder B.

Other than in the case of related companies (which is a term defined in the Companies Act 1993) the definition of associate is an open-ended rule that turns on the particular facts and the surrounding circumstances.

When determining whether an association is created by any arrangement or agreement, the Panel considers all facets of the relationship between the parties. These may include, but are not limited to:

- the parties' relationship before entering into the arrangement;
- the circumstances around the negotiation of, and entry into, the arrangement;
- the existence of any other agreements, commitments, understandings or expectations; and
- any relevant common interests of the parties.

A relationship is particularly likely to be considered one of association for Code purposes where it concerns the future control of voting rights of the Code company.

Individual elements on their own may not constitute an associate relationship. For example a relationship of trust and co-operation may not in itself determine associate status. However the

combined elements of a relationship may strongly support a finding that in the circumstances parties should be regarded as associates. The Panel considers each element separately and then as a whole to assess the combined impact.

Associate status cannot be negated merely by a contractual acknowledgement that a particular party will not control the voting rights of another party.

Some situations which the Panel has considered show the Panel's interpretation of the term "associate". These are outlined below.

EXAMPLES OF ASSOCIATION

Bridgecorp Capital Limited

In late 2004 Bridgecorp Capital Limited acquired 19.99% of the voting rights in Dorchester Pacific Limited from Mr Brent King, the managing director of Dorchester, and from other interests. Mr King retained 5.05% of Dorchester and subsequently purchased a further 0.9% of Dorchester. Consequently King and Bridgecorp held 25.94% of Dorchester between them. At the same time that King and Bridgecorp entered into the sale and purchase agreement in respect of 19.99% of Bridgecorp, they also entered into an agreement described as a "lock-up deed" which was in substance an option deed.

To decide whether Bridgecorp and King were associates, the Panel considered the facts around the entering into of each agreement and the expectation of the parties after the agreements.

The sale and purchase agreement between Bridgecorp and King provided for a number of ongoing relationships such as:

- an employment commitment by King to remain as CEO of Dorchester for a period;
- a restraint of trade for King, preventing any competition with Dorchester's business within 6 months of his leaving Dorchester's employment, should he do so; and
- a restraint on King buying any more shares in Dorchester for 12 months.

The option deed provided for:

- the payment of $600,000 by Bridgecorp to King for an option;
- a standstill on King's shares (preventing him from selling his remaining Dorchester shares);
- an option (for 10 months) for Bridgecorp to purchase the remainder (5.05% of Dorchester's voting rights) of King's Dorchester shares at a fixed price; and
- a commitment by King to accept a possible future takeover offer by Bridgecorp (although Bridgecorp did not commit to making such an offer).

The Panel considered that as a result of these ongoing contractual provisions relating to the future control of voting rights in Dorchester and other commitments the parties were associates under the Code. Their combined holding of voting rights after the transactions exceeded the 20% threshold and consequently the acquisition of voting rights was in breach of the Code.

After making its determination the Panel accepted enforceable undertakings from Bridgecorp to sell down approximately 5% of the voting shares of Dorchester and from King to sell down approximately 0.9% of the voting shares in Dorchester. These sales put Bridgecorp and King back in the position they would have been in had their acquisitions as associates complied with the Code. The two parties also undertook to unwind the option deed and elements of the sale and purchase agreement, thus removing contractual elements of their association.

Prime Infrastructure Networks (New Zealand) Limited

Another example of association through a contractual agreement (this time a genuine lock-up agreement) and acquisitions by associates arose in the Prime/Powerco takeover. This was a takeover offer by Prime Networks, a subsidiary of Prime Infrastructure Management Limited (PIML), for all of the equity securities in Powerco.

PIML entered into lock-up agreements with four shareholders in Powerco in August 2004. The four shareholders, known as the Council shareholders, together held approximately 53.65% of the shares in Powerco. The lock-up agreements:

- required Prime networks to make a full takeover offer for Powerco within a specified period, and
- required the Council shareholders to accept that offer.

The Panel's view was that the lock-up agreements between PIML and the Council shareholders created an associate relationship between those parties. Consequently the subsequent on-market acquisitions of 1.27% of Powerco shares by PIML's subsidiary, Prime Infrastructure Networks (Australia) Pty Limited (Prime Australia), would be in breach of the Code as the combined holdings of PIML and the Council shareholders exceeded the 20% limit imposed by rule 6. These views were conveyed to Prime Australia's legal advisers. Although not necessarily accepting that PIML and the Council shareholders were associates, Prime Australia sold the acquired shares almost immediately.

The importance of the associate principle is clear because otherwise, potentially, PIML could have bought up to a total of 20% of the voting rights on-market before launching its takeover, even though it had pre-bid commitments for over 50% of the voting rights in Powerco.

Kiwi Income Property Trust/Sovereign Assurance Limited

In November 2004 Kiwi Income Property Trust (Kiwi) acquired 19.9% of the voting rights in Capital Properties Limited (Capital Properties), a Code company. The 19.9% was acquired when voting rights bought by Kiwi in a stand in the market were added to the holdings of its associate Sovereign Assurance Company Limited (Sovereign). Sovereign and Kiwi were related through common upstream ownership of Kiwi's management company and Sovereign.

Subsequently Sovereign bought more Capital Properties shares on market, which increased the aggregate holdings of Kiwi and Sovereign to just over 20%.

When notified of these acquisitions the Panel immediately contacted Sovereign seeking an explanation. Sovereign recognised its error and immediately sold down sufficient shares to reduce the combined holding of Kiwi and Sovereign in Capital Properties to below 20%.

Gould Holdings Limited and the Rutherford family

Designer Textiles (N.Z.) Limited (DTL) (now Pod Limited) is a Code company. In February 2003 its major shareholder was Gould Holdings Limited (GHL), an investment company controlled by Mr George Gould, with a 24.69% stake.

Mr Gould had had a long association with the Rutherford family. In the latter part of 2002 the members of the Rutherford family sold their investment company, Amuri Securities Limited (ASL), to GHL in exchange for shares and convertible notes in GHL. After Mr Gould had subscribed for some additional capital in GHL the Rutherford family held 21.24% of GHL while Mr Gould, through a separate company Gould Investments Limited (GIL), held 78.76%.

The question of association between the Rutherford family and Mr Gould arose in connection with various acquisitions of shares in DTL itself by members of the family.

Several Rutherford family members had acquired direct investments in DTL on a number of separate occasions and by February 2003 these holdings amounted to some 8.8% of the total voting rights in DTL. They were in addition to the 24.69% held by GHL.

If the Rutherford family were associates of Mr Gould or GIL at the time they had acquired these parcels of shares, the acquisitions would have been in breach of the Code.

The Panel concluded that Mr Gould, GIL and GHL were associates of the Rutherford family for a combination of reasons including:

- the time period over which Mr Gould had had a personal and business relationship with members of the Rutherford family, particularly through managerial and advisory relationships in Amuri Corporation Limited, South Eastern Utilities Limited, ASL and finally GHL;
- the closeness of the relationship, as evidenced by the trust showed by the Rutherford family in Mr Gould, including their willingness to invest in GHL on the basis of minimal documentation and without any direct input into management of the investments of that company;
- the financial commitment made by the Rutherford family to GHL, at a time when the sole asset of GHL was a substantial shareholding in DTL and several members of the Rutherford family themselves had significant shareholdings in DTL.

All three elements (business, personal and ownership relationships) of the extended definition of "associate" in rule 4(1)(d) were present in the relationship between Mr Gould and the Rutherford family. A rule 4(1)(d) relationship does not need to exhibit any agreement or arrangement relating to the control of voting rights in the company.

The Panel determined that the associate status crystallised on 11 September 2002 (when the Rutherford family confirmed their investment in GHL) and that consequently all acquisitions of DTL securities by Rutherford family members after that date were in breach of rule 6(1)(a). The parties at fault were required to divest those holdings that had been acquired in breach of the Code.

The family members gave enforceable undertakings that the relevant shares would be sold within six months of the Panel's decision and subsequently confirmed that this had been done.

ABC Learning Centres Limited

The Panel recently granted an exemption when the issue of association arose relating to Kidicorp Group Limited (Kidicorp). This exemption involved merger transactions in Australia by ABC Learning Centres Limited (ABC) with two Australian companies, Child Care Centres Australia Limited (Child Care Centres) and Peppercorn Management Group Limited (Peppercorn). Both Child Care Centres and Peppercorn had interests in Kidicorp. Peppercorn arguably controlled Child Care Centres.

In October 2004 the Panel granted an exemption to ABC and its wholly-owned subsidiaries from rule 6(1) of the Code in respect of any increase in their voting control in Kidicorp as a result of the mergers.

The exemption was required because Child Care Centres, which had a very modest shareholding in Kidicorp, was an associate of the controlling shareholders of Kidicorp. A management agreement between Kidicorp and Peppercorn, and a first right of refusal agreement between the controlling shareholders of Kidicorp and Child Care Centres, established the relationship. Rule 6 of the Code prohibited ABC from acquiring control of

Child Care Centres' modest voting rights in Kidicorp because of these associations.

The management agreement obliged Peppercorn to manage all of Kidicorp's childcare facilities on an exclusive basis under a long-term contract with Kidicorp.

The first right of refusal agreement required the major shareholders of Kidicorp (holding 56.82%) to offer their relevant shares to Child Care Centres/Peppercorn if they sought to sell all or any of the shares covered by the agreement. It also committed the shareholders to accepting a full takeover offer made by Child Care Centres/Peppercorn should it be made. Further, if Child Care Centres/Peppercorn decided to purchase shares under rule 7(c) of the Code, they were required to make an offer to all the major shareholders for their Kidicorp shares. The agreement was indefinite until all the Kidicorp shares it covered were sold to Child Care Centres/Peppercorn or it was cancelled by mutual consent.

The Panel decided that the agreements established an associate relationship between the major shareholders of Kidicorp and Child Care Centres.

The exclusive management agreement (entered into slightly earlier than the first right of refusal agreement) may not have been sufficient of itself to constitute the parties as associates for Code purposes since it was a management agreement, albeit an exclusive one, rather than being concerned with voting rights.

An exemption was appropriate because ABC's increased voting rights in Kidicorp would be a consequence of merger transactions in Australia which were not undertaken for the purpose of increasing those voting rights. Also, the value of Kidicorp's assets was small in relation to those of the three Australian companies. It would not be appropriate for the fate of the Australian mergers to be decided by the minority shareholders of Kidicorp. The ABC exemption was consistent with the Panel's approach to other overseas upstream acquisitions caught by the Code.

The exemption was necessary because ABC would become an associate of the major shareholders of Kidicorp after one or both mergers and accordingly its acquisition, through the merger, of control of a small shareholding in Kidicorp would be in breach of rule 6 of the Code.

ABC, following the successful mergers with both Peppercorn and Child Care Centres in late 2004, is not able to acquire control of any shares in Kidicorp (including shares from the majority shareholders under the first right of refusal agreement) unless the provisions of the Code (shareholder approval or takeover) are complied with.

Lock-up agreements and the Code

The Panel has made it clear that lock-up agreements (entry into an agreement under which one party is agreeing to make a bid and the other party is agreeing to sell into it) are legal in New Zealand, but this does not mean that they have no consequences under the Code – they do. This can be seen from the above examples.

A lock-up agreement, by its very nature, will make the parties associates. That is not a breach of the Code but it means that the parties' voting rights must be aggregated and this may limit their ability to undertake acquisitions of more voting rights.

SHAREHOLDER APPROVAL

The associate provisions of rule 4 are an anti-avoidance mechanism. However, the Code provides the means, through rule 7(c) in particular, for the shareholders of a code company to approve any acquisition of voting shares. Consequently, where as a result of the association an acquisition of voting shares would be in breach of rule 6(1), the acquisition can be approved by shareholders.

CONSEQUENCES OF ASSOCIATE STATUS

It is important to emphasise that it is not a breach of the Code to become associates. What is important are the consequences of that status. Parties that are or become associates and wish to acquire voting rights must aggregate their holdings to determine whether the proposed acquisition would be in breach of the fundamental rule.

The examples set out above illustrate the fact-specific nature of the association rules in the Code and their relationship with the acquisition of voting rights and the fundamental rule contained in rule 6(1). The breach in each case was not the creation or existence of the associate status. Rather it was the acquisition of voting rights when, after that acquisition, the associated parties' aggregate holding of voting rights exceeded the 20% threshold.

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