

**5<sup>th</sup> Annual Competition Law & Regulation Review**

**Update on the Operation of the Takeovers Code**

**John King  
Chairman  
Takeovers Panel**

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**Introduction**

The New Zealand Takeovers Code has had a very successful introduction. It has been well received, even by people originally opposed to having a Code at all. It has received good press, sometimes almost effusive. Such a charmed run was bound to come to an end, and this happened last year with the unforeseen consequences of the Powerco exemption. It was a controversial takeover made even more so by the exploitation of the Panel's exemption.

Fortunately, this event does not indicate any defect in the Code. It was an unusual event in which a standard exemption triggered an unusual response. I will have more detail on the Powerco exemption a little later.

Powerco was just one event in what has been an extremely busy year for the Takeovers Panel. In the last 12 months nine takeover offers have been made for New Zealand code companies. These have involved the Panel in reviewing offer documents and target company statements, approving independent advisers, considering applications for exemptions and, where necessary, taking enforcement action.

Exemption applications and enforcement actions have dominated the Panel's activity.

Today I will focus on those two aspects of the Panel's work. On exemptions I will discuss the nature of the Panel's exemption power and two issues which arise in a number of exemption applications - upstream transactions and differential treatment of offerees.

On enforcement I will cover the main enforcement related issue that arose this year, the interpretation of the word "associates" in the Code and the consequences of associate status.

**The Panel's exemption power**

The Panel has the power under section 45 of the Takeovers Act to grant exemptions from compliance with the Code.

In the past year the Panel has had more exemption applications than usual and this raises concerns. The volume and nature of these applications appear to indicate that market participants do not fully understand the purpose of and limitations on the Panel's exemption powers.

The Panel recently issued a guidance note to help market participants understand when exemptions are likely to be granted. This is available on our website. However, today I will take the opportunity to explain the Panel's exemption power and policy regarding the granting of exemptions.

The Code applies equally to all market participants. All market participants are obliged to conduct their affairs on the basis of the Code, and conversely they and investors are entitled to rely on the protections contained in the Code.

Increasingly market participants have been seeking exemptions to enable them to avoid complying with the Code, or to use alternative transaction structures, with a view to achieving a particular commercial outcome or benefit. The Panel cannot and will not grant exemptions in these situations.

At first glance the Panel's power to grant exemptions seems very wide. The Panel can grant exemptions to any person, or class of persons, from compliance with any provision of the Code on such terms and conditions as it thinks fit. However, the power is constrained by section 45(4A) of the Takeovers Act 1993 which requires that the Panel's reasons for granting an exemption must include:

- why it is appropriate that the exemption is granted; and
- how the exemption is consistent with the objectives of the Code.

Some applicants seek, in support of their exemption applications, to refer solely to the objectives of the Code in section 20 of the Takeovers Act. However, these were the objectives the Panel was required to consider in formulating the Code.

The way these objectives were interpreted and balanced against each other can be seen in the Code that was ultimately gazetted and became law. For example, the objective in section 20 of the Act of "*assisting in ensuring that the holders of securities in a takeover are treated fairly*" is reflected in rule 20 of the Code which says that an offer must be made on the same terms and offer the same consideration to all shareholders of the same class. Consequently, the obligations and requirements of the Code itself, not just the objectives in the Act, should be considered carefully by an applicant seeking an exemption.

Because an exemption must be consistent with the objectives embodied within the Code, the Panel's exemption power is limited. The purpose of the Panel's exemption power is to address situations where the Code has unintended consequences or may not adequately provide for unexpected or unusual circumstances. The class exemptions that came into force on 1 July 2001 illustrate very clearly the purpose of the exemption power. It is not intended to enable market participants to avoid or modify provisions of the Code so that they can structure a transaction in a manner that does not comply with the Code.

In the past year the Panel received exemption applications which did not appear to appreciate the nature of and limitations on the Panel's exemption power. A number of these applications involved two issues - upstream acquisitions and the application of rule 20. I will discuss these two issues, using recent offers as case studies.

#### *Upstream acquisitions*

The Code was deliberately constructed to capture the acquisition of control of voting rights in code companies by a transaction upstream from the direct holder of voting rights in the code company. Control of voting rights in a code company can be transferred as a result of such a transaction and so it should not occur without the prior approval of the code company's shareholders.

When voting rights in a code company are controlled by a parent company but held by a subsidiary, the Code provides in rule 7 two alternatives which bidders can use to gain control of these voting rights:

- the purchaser could make a full takeover offer for the shares in the code company which the controller of the voting rights could ensure was accepted by its subsidiary; or
- the code company could seek the approval of its shareholders under rule 7(c) to an upstream transaction which would result in the purchaser acquiring the subsidiary which holds the voting rights in the code company.

The Panel has received applications for exemptions to allow the transfer of control of voting rights by means of an upstream acquisition of a subsidiary company as an alternative to the two methods provided by the Code.

The most recent application of this nature was from Vector Limited for its takeover offer for NGC Holdings Limited.

In October 2004 The Australian Gas Light Company Limited (AGL) controlled, through a New Zealand holding company, 64.25% of the voting rights in NGC. AGL wished to sell its interest and sought bids from prospective purchasers. Vector Limited was the successful bidder and entered into an agreement to acquire AGL's interest in NGC.

Vector, after negotiations with AGL, did not wish to use either of the alternatives provided by the Code. The direct takeover alternative potentially had taxation disadvantages for AGL, and AGL did not wish to go through the shareholder approval process under rule 7(c).

Vector sought an exemption from the fundamental rule (rule 6(1)) of the Code to enable it to become the controller of the 64.25% of the voting rights in NGC by acquiring AGL's New Zealand holding company without the approval of NGC shareholders. This was on the basis that Vector would make an offer for the remaining NGC shares for the same consideration per share that was used to calculate the price for the shares in the AGL holding company.

The issue for the Panel was whether the grounds put forward by Vector in support of an exemption were appropriate and consistent with the objectives of the Code.

The Code captures the acquisition of voting rights in code companies by an upstream transaction. In the Vector case applying the Code would not have had unintended or unexpected results. Vector and AGL could have used the mechanisms provided by the Code. Instead they proposed to structure the transaction in a way that did not comply with the Code to provide taxation benefits and commercial convenience to AGL.

The Panel's exemption power is not intended to enable market participants to avoid or modify provisions of the Code so that they can structure a transaction in a manner that does not comply with the Code. The reasons advanced by Vector to support its application were not proper grounds for the Panel to exercise its exemption power. Accordingly, Vector's application was declined.

Vector argued that there was a precedent for the exemption which it sought. It argued that the Panel had granted an exemption to Origin Energy New Zealand Limited to allow it to acquire control of more than 50% of the voting rights in Contact Energy Limited, a code company, by acquiring a New Zealand holding company from its parent Edison Mission Energy.

The facts of the Origin Energy exemption were different from those of the Vector application. The circumstances of the Origin Energy application were unique in that the loss of complex upstream financing arrangements could have resulted in a negative pricing effect for all Contact shareholders, if the sale of the controlling block of shares had not taken place at the holding company level. The exemption was not granted to accommodate the commercial interests of the holder or acquirer of the controlling shareholding block. Rather it

was granted to avoid a possible detrimental effect on the consideration offered to all shareholders.

The Panel treats every exemption application on its own merits. Applicants should not assume that an exemption will be granted to them on the basis of a previous exemption.

In general the Panel will not grant exemptions to permit upstream transactions to occur without the approval of shareholders. The Code provides an appropriate mechanism for upstream transactions to be approved. Market participants considering a transaction to acquire control of voting rights in a code company by purchasing a holding company, should assume that they need to comply with the Code and rule 7(c) in particular.

The only qualification to the Panel's policy on upstream acquisitions is in relation to an overseas amalgamation or takeover which increases a person's control of voting rights in a New Zealand code company, but was not undertaken for that purpose. The Panel will only grant exemptions from the fundamental rule in such circumstances if it is satisfied that the change of control of voting rights in the code company is merely incidental to the overseas transaction, and the shares in the code company are a very small percentage of the assets being acquired. An example is the Takeovers Code (Canadian National Railways Company) Exemption Notice 2001.

#### *Rule 20 – equal treatment*

One of the fundamental tenets of the Code, contained in rule 20, is that offers have to be made on the same terms and provide the same consideration for all securities of the same class.

The Panel can only grant exemptions where applying the Code has unintended consequences or may not adequately provide for certain circumstances. The principles applied by the Panel can be seen from two applications for exemption from rule 20 recently considered by the Panel. They are:

- an application to pay different consideration to a major shareholder in a proposed offer; and
- an application to pay different consideration to overseas shareholders.

#### Differential offers to major shareholders

I will again use the Vector takeover offer for NGC as a case study because we have already outlined the background to that offer.

After the Panel declined Vector's initial application for an exemption to enable an upstream acquisition without shareholder approval, Vector decided to make a full takeover offer for NGC. AGL agreed with Vector that its New Zealand holding company would accept the offer. Vector proposed to offer consideration made up of:

- a cash sum of \$2.91 per share, plus
- a preferential entitlement to an allocation of Vector shares in the event that Vector makes a public offering of its own shares.

However, Vector had agreed with AGL that its New Zealand holding company would waive its rights to the preferential entitlement, and the entitlement would not be offered to it under the takeover offer. Vector sought an exemption from rule 20 to allow it to offer consideration to AGL's holding company on different terms from those for remaining shareholders.

In support of its application Vector argued that an exemption to allow a major shareholder to accept less consideration would be appropriate because AGL, as a large shareholder, did not require the protections of the Code. Vector argued that as majority shareholders have a strong negotiating position they should be allowed to agree to receive less consideration provided that this would not disadvantage other shareholders. Vector also argued that an exemption would be appropriate because it would allow small shareholders to be offered an additional element of consideration.

This was not a proper basis for the exercise of the Panel's exemption power.

Rule 20 is a fundamental requirement of the Code. It should not be relaxed by an exemption based on an assessment of a commercial outcome that may or may not be desirable for a particular group of shareholders. An exemption would have resulted in one shareholder being offered less than others. This is not consistent with rule 20 of the Code.

#### Scrip offers and overseas shareholders

The circumstances of Vector's application are very different from scrip offers to overseas shareholders for which the Panel has granted exemptions from rule 20.

A number of offerors making scrip offers have sought exemptions from rule 20 to allow them to offer overseas shareholders cash only rather than scrip.

Without an exemption offerors must ensure that their offer complies with securities laws in every country where target company shareholders reside, as well as complying with New Zealand securities law. Checking out the cost of compliance with the law, as well as compliance with the law itself, in numerous other countries increases the cost and complexity of making a scrip offer for a New Zealand code company.

In contrast with applications about differential offers to major shareholders, exemptions for scrip offers and overseas shareholders address a situation where the provisions of the Code have an unintended and undesirable outcome. Scrip offers are an important part of the takeovers market. However, without an exemption the existence of overseas target company shareholders would have an undesirable effect on the ability to make scrip offers.

The Panel has a policy that enables it to grant exemptions from rule 20 for offers to overseas shareholders but only if it is satisfied that:

- the number of overseas shareholders in any jurisdiction is extremely small; and
- that the alternative consideration to be offered to overseas shareholders is equivalent to that being offered to remaining shareholders.

The exemptions will not be granted when there are a significant number of overseas shareholders or where it is known that the offer can be properly made using the New Zealand offer documents. This ensures that the purpose of rule 20 is preserved.

This policy was applied to exemptions granted to Independent Newspapers Limited, Normandy NFM and Wrightson Limited when making scrip or scrip and cash offers. In those cases a nominee sold the scrip that would have been allotted to each overseas shareholder and the proceeds were paid to the overseas shareholders. Thus the overseas shareholders were in the same position as New Zealand shareholders who immediately sold

the scrip they received under the takeover offer. In these cases the scrip was easily realisable in an established market because it was listed at the time the offer was made..

The same policy also applied to an exemption granted to Prime Infrastructure Networks (New Zealand) Limited (Prime Networks) for an offer for Powerco Limited. The Panel granted an exemption from rule 20 to allow certain overseas shareholders, who at the time of the application held less than 1% of Powerco's total issued shares, to be offered cash. An independent adviser was required to certify that the cash to be offered was of equivalent value to the cash and scrip consideration offered to New Zealand shareholders.

Because the scrip being offered was new and was not listed, the Panel considered that the nominee approach adopted for Independent Newspapers and Normandy NFM was not appropriate in this case. The certificate of equivalence was obtained, but the exemption was exploited because of a view that the fixed cash amount was better than the complex and uncertain cash and scrip consideration offered to New Zealand shareholders. This view was supported by the rule 21 adviser and actively promoted by share brokers and advisers,

The number of "overseas" shareholders increased dramatically as shareholders sought to obtain the benefit of the exemption and there was a flurry of comment in the news media. The policy behind the exemption was consistent with the Code but the conditions were exploited in an unexpected manner as a result of the complexity of the offer to New Zealand shareholders. Contrary to much external comment the Powerco exemption does not indicate any defect in the Code. Rather it was an unusual event in unusual circumstances. The Panel will ensure that the conditions of future exemptions from rule 20 relating to overseas shareholders do not provide the opportunity for such exploitation.

#### *Making exemption applications*

Before moving on to discuss enforcement issues, I would like to conclude this section of my presentation on exemptions by reminding market participants that it is important that applications for exemptions contain full details of the purpose and surrounding circumstances of a transaction in respect of which an exemption is sought. This is necessary so that the Panel fully understands the background to the application. Applicants should bear in mind that to omit to give the Panel all relevant information about a transaction in support of an application may constitute an attempt to mislead the Panel. This would be an offence under section 44 of the Takeovers Act.

The Panel encourages all market participants to refer to our guidance note on exemptions. A proper understanding of the principles for the granting of exemptions will reduce the number of exemption applications, saving time and expense for all parties and the Panel.

#### **Enforcement**

One of the Panel's functions is to investigate any act or omission for the purpose of exercising its powers to make determinations, orders and applications to the Court. The Panel has spent a considerable amount of time and resources carrying out this function in the past year. One issue has led to a number of investigations and enforcement action - the interpretation of the definition of "associate" in the Code and the consequences of associate status.

### *Associates and Acquisitions*

The 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. It was essential that the Code include 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.

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 allows another person to control 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, 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 and entering of the arrangement;
- the existence of any other agreements, commitments, understandings or expectations; and
- the parties sharing any relevant common interests.

A relationship is particularly likely to be considered one of association for Code purposes where it concerns the future control of the 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 does not always 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 recent situations which the Panel has considered show the Panel's interpretation of the term "associate".

#### Bridgecorp Capital Limited

Last year 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 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 the 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.

In September 2004 Prime Infrastructure Networks (Australia) Pty (Prime Australia), another subsidiary of PIML, acquired 1.27% of Powerco shares on-market in separate transactions before the takeover offer was made.

The Panel had to consider whether, at the time of the on-market acquisitions, PIML and the Council shareholders were associates under the Code as a result of being parties to the lock-up agreements. If so, the subsequent on-market acquisitions would not comply with rule 6 as the combined holding of PIML and its associates was above 20%.

The Panel's view was that the lock-up agreements between PIML and the Council shareholders created an associate relationship between those parties. Consequently Prime Australia's on-market acquisitions would be in breach of the Code. 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 buy 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) made a stand in the market which, with its associate (a related company), Sovereign Assurance Company Limited (Sovereign), gave it 19.9% of the voting rights in Capital Properties Limited (Capital Properties), a code company.

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

These acquisitions were brought to the attention of the Panel. The Panel executive immediately contacted Sovereign seeking an explanation. Sovereign recognised its error and immediately sold down sufficient of those shares to reduce the combined holding of Kiwi and Sovereign in Capital Properties to below 20%.

Consequences of associate status

It is important to emphasise that it is not a breach of the Code to become associates. What is important is the consequence of that status. Parties that are or become associates must

aggregate their holdings when calculating their total voting rights to determine whether they will breach the 20% threshold of the fundamental rule.

The Panel has made it clear that lock-up agreements are legal in New Zealand. This does not mean that they have no consequences under the Code – they do. A lock-up agreement will almost inevitably render the parties associates. That is not a breach of the Code but it means that their voting rights must be aggregated which may limit their ability to undertake acquisitions of voting rights.

In the above cases the breach was not the creation or existence of the associate status. Rather it was the acquisition of voting rights in the situation where after that acquisition the associated parties' aggregate holding of voting rights exceeded the 20% threshold.

### **Harmonisation with Australia**

The issue of harmonisation of the New Zealand Takeovers Code with Australian takeovers law was addressed when the New Zealand Code was formulated. At that time section 24 of the Takeovers Act provided that:

*“In formulating a takeovers code the Panel shall have regard, as far as practicable, to the principles applying to the harmonisation of business law contained in the Memorandum of Understanding between the Governments of Australia and New Zealand on the Harmonisation of Business Law signed at Darwin on the 1<sup>st</sup> day of July 1988”.*

The Panel's approach to the formulation of the Code was to produce a Code which was appropriate for the New Zealand takeovers market, taking into account the requirements of section 24.

The legal framework governing takeovers in Australia is very different from the framework provided by our Takeovers Act. There are differences in the legislation and in the role of the Panel. Unlike New Zealand, the Australian Securities and Investments Commission (ASIC), the equivalent of our Securities Commission, fulfils some of the functions performed by our Panel. Furthermore, the Australian Panel has a much wider jurisdiction in that it aims to correct situations which are described as “unacceptable circumstances”.

Harmonisation does not require either country to follow blindly in the footsteps of the other. The aim is to have a common purpose and similar principles. Differences in approach arise for historical reasons and because of the particular requirements of each jurisdiction.

It is in this sense that there is “harmonisation” between the takeovers regimes in New Zealand and Australia. They both seek to place a framework over takeover activity to ensure an orderly process where shareholders are treated equally and, on the basis of proper disclosure, are able to make an informed decision. In particular we have adopted a common threshold of 20%.

For Australian investors the adoption of the New Zealand Code meant that the basically uncontrolled nature of the takeovers market in New Zealand had come to an end. Australian investors now participate with all other shareholders in the takeover process in a manner that in principle produces outcomes similar to the outcomes under Australian law.

An aspect of harmonisation is being addressed by the Securities Legislation Bill now before Parliament. At present, unlike the Australian Panel, the New Zealand Panel has no power to deal with situations where, although the Code has been complied with, the parties in the takeover contest engage in misleading or deceptive conduct. The new law will amend the Code to prohibit such conduct and give the Panel powers to deal with any misleading or deceptive conduct.

I see no other significant harmonisation issues relating to the current takeover regimes in Australia and New Zealand.

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