Reverse takeovers consultation paper
DLA Piper submission

DLA Piper submits that a vote by the bidder's shareholders should only be required if the reverse bid will lead to a change in the 'main undertaking' of the bidder.

A reverse scrip takeover bid is one where a listed bidder offers, typically, new shares in itself for the shares in a larger entity. If the transaction is successful, the shareholders in the target will end up owning more than half the shares in the bidder.

The following views have been expressed to ASX in support of a requirement for shareholder approval by the bidder:

- shareholders in the bidder should have a say in matters that will:
    - significantly dilute their ownership interests, or
    - otherwise transform the nature of the entity in which they are owners
- the ASX listing rules are out of line with other international exchanges (including London, New York, Hong Kong, Singapore and Toronto) which require shareholder approval for such transactions.

It is pleasing that ASX does not mention any control effects of reverse takeovers in support of a review of regulation. Control effects are already regulated by the Takeovers Panel and, in the context of takeovers by scheme of arrangement, by the Australian Investments & Securities Commission (ASIC). Any role for ASX should be limited to any important issue which is within the scope of ASX's function and which has not been regulated by ASIC or the Takeovers Panel.

As for ASX's listing rules being out of line with other international exchanges - as ASX notes in its consultation paper, it is difficult to place much weight on this by itself without considering all aspects of the regulation of reverse takeovers in those markets.

That leaves the contentions that the bidder's shareholders should have a say in matters that will:

- significantly dilute their ownership interests, or
- otherwise transform the nature of the entity in which they are owners.

Dilution of ownership interests

The dilution of a shareholder's proportion of the total number of shares in the bidder is not of itself adverse to the shareholder. If the regulation of control issues is left with the takeover regulators (ASIC and the Takeover Panel), then dilution is only adverse if it brings a dilution of value.

A dilution of value could, in theory, arise either because:

- a strategic or controlling stake in the bidder would have attracted a premium before the reverse takeover bid, but would be diluted to the point where it would no longer attract a premium after the bid, or
- the scrip offer ratio under the bid was by itself value dilutive - that is, the bidder was offering more of its shares for shares in the target than the target's shares were worth.

The loss of premium value of a controlling or premium stake is a relevant argument, but not a strong argument. Because Australia's takeover laws require all target shareholders to receive the same price in a takeover transaction, it is not clear that strategic or controlling stakes should be treated as having a premium value. Outside change of control transactions, large stakes often trade at a discount, and not a premium, to market value.

In any event, ASX's Consultation Paper does not mention the possible loss of premium value of a strategic or controlling stake in the bidder as a reason for any new requirement for bidder shareholder approval.

What of the possibility that the scrip offer ratio under the bid may by itself be value dilutive? Well, this is a risk under any takeover bid. The general company law of directors' duties would normally require that the bidder's directors not authorise a transaction which they considered was likely to be value dilutive for the bidder's shareholders.

It is true that if the bidder is overpaying, then the effect will be more value dilutive in the case of a reverse takeover bid, where the bidder is smaller than the target, than in the case of a bid where the bidder is larger than the target. Does that mean that in this particular case, but in no other cases, shareholders should have a right to veto the bid offer ratio?

The arguments that reverse takeover bids have a peculiar potential to be value dilutive do not seem to be compelling. No data is presented in the Consultation Paper that would support the arguments.

Otherwise transform the nature of the entity in which they are owners

What sort of prospective transformation of the bidder is contended to require bidder shareholder approval is not explained in the Consultation Paper.

ASX does regulate to some extent transactions by a listed entity that would result in a major change to the nature of the security holders' investment in the entity (Listing Rule 11). It does this by requiring shareholder approval of the disposal by a listed entity of its 'main undertaking' (Listing Rule 11.2) and, in some cases, requiring shareholder approval for other changes in the nature or scale of the entity's activities (Listing Rule 11.1).

ASX does not normally treat a reverse takeover transaction as falling within the scope of Listing Rule 11.1.

Any unnecessary regulation of listed entities which want to acquire a target would put them at a competitive disadvantage to unlisted acquirers, resulting in a diversion of value from the listed to the unlisted space.

Extending Listing Rule 11.1 to reverse takeovers would present execution challenges for reverse takeovers.

In most cases it would not be practical to obtain the bidder's shareholders' approval before the bid period. It would commonly take at least eight weeks to prepare for, give notice of and hold a shareholders' meeting to vote on the required resolution. Adding that much time to the front of a

bid would often increase the risk of a competing bid and make it harder for the bid to gather momentum.

Making a bid that is subject to approval by the bidder's shareholders during the bid period would present several challenges:

- commercially, such a condition would be unattractive to the target, and would make it harder to obtain the recommendation of the target's board, because the condition would in effect give the bidder's shareholders a call option on the bid
- target shareholders would be unlikely to accept offers under the bid before the condition was satisfied, making it difficult for the bid to win any early acceptances, and
- such a condition may in some circumstances be void as a condition within the control of the bidder (Section 629 Corporations Act), although if ASX did extend Listing Rule 11.1 to reverse takeovers ASIC may be prepared to modify the operation of this provision.

Putting aside the transaction execution challenges, there is perhaps a case for a requirement for bidder shareholder approval if the bid will result in a major change to the nature of the bidder's main undertaking. That would be consistent with ASX's general policy on Listing Rule 11 (see in particular Guidance Note 12 paragraph 3.2(3)). Such a change may result in a change to the investment characteristics of shares in the bidder, and there may not be sufficient liquidity in the bidder's stock for shareholders who don't like that change to exit the stock at a reasonable price.

The mere fact that a bid will transform the size of the bidder should not trigger any additional regulatory requirement, for the reasons touched on above in relation to dilution.

It will be a very unusual transaction in which a reverse takeover bid would lead to a major change to the nature of the bidder's main undertaking. Most reverse takeovers involve a bidder and target from the same industry. Such transactions will usually not lead to a major change to the investment characteristics of shares in the bidder.

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