GAMBOTTO v WCP LTD:

ITS IMPLICATIONS FOR CORPORATE REGULATION

EDITOR

IAN M RAMSAY

Harold Ford Professor of Commercial Law
The University of Melbourne

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Ph: 61 3 9344 5332
Fax: 61 3 9344 5285
Email: cclsr@law.unimelb.edu.au

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Part I

Introduction

Chapter 1

Key Aspects of the Decision of the High Court in Gambotto v WCP Ltd

Ian M Ramsay[1]

The Controversy

Few corporate law judgments have led to the publicity and controversy that resulted from the decision of the High Court of Australia in *Gambotto v WCP Ltd.*[2] When the decision (in which the High Court refused to allow the expropriation of the shares of a minority shareholder against his will) was handed down on 8 March 1995 it was the subject of extensive media coverage and vigorous debate among corporate law commentators. The day following the decision, the *Australian Financial Review*, in a front page story, referred to it as a "ruling that has radically altered the balance of power within corporate Australia".[3] In the same edition, a columnist stated that the decision "appears, at first glance, to have turned Australia into a greenmailer's paradise".[4] Another commentator stated that the decision seemed to upset the balance between protecting the rights of minority shareholders and enabling the market for control of companies to function efficiently and with certainty.[5] Others disagreed. The editor of the *Australian Financial Review* argued that "the spirit of Mr Gambotto's historic victory deserves to remain part of Australian company law".[6]

More significantly, the decision has been cited as a key reason for the demutualisation of the National Roads and Motorists Association (NRMA) not proceeding. The board of directors of NRMA stated that the *Gambotto* decision, along with a Federal Court decision which found the NRMA prospectus misleading,[7] meant that "the proposal for demutualisation was no longer viable".[8] The decision has also led to recommendations for law reform. Most recently, in January 1996, the Companies and Securities Advisory Committee recommended amendments to the Corporations Law that would limit the

1 Harold Ford Professor of Commercial Law and Director of the Centre for Corporate Law and Securities Regulation, Faculty of Law, The University of Melbourne.

2 (1995) 182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243.

3 *Australian Financial Review* 9 March 1995 at 1.

4 Ibid at 60.

5 *The Age* 9 March 1995 at 24.

6 *Australian Financial Review* 10 March 1995 at 28.

7 *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590.

8 *Australian Financial Review* 29 May 1995 at 5.

application of *Gambotto* to a range of corporate transactions concerning the compulsory acquisition of minority shareholdings.[9]

The Facts of Gambotto

In May 1992 WCP Ltd ("WCP") held a meeting of its shareholders at which an amendment to the articles of association of WCP was approved. The effect of the new article (article 20A) was to enable any member of the company who was "entitled for the purposes of the Corporations Law to 90% or more of the issued shares" to acquire compulsorily, before 30 June 1992, all the issued shares in WCP, not being shares to which the majority members were entitled. The price was to be $1.80 per share. The members of the company received an expert's report valuing the shares at $1.365 per share. The appellant before the High Court, Mr Gambotto, conceded that this price represented a fair valuation by an independent expert.

WCP had an issued share capital of almost 17 million ordinary shares of 20 cents each. The majority shareholders, who were wholly-owned subsidiaries of Industrial Equity Limited, held approximately 99.7% of the issued capital. The remaining 50,590 shares were held by minority shareholders including the appellant. Mr Gambotto and the other appellants before the High Court objected to the compulsory acquisition even though they conceded that the price for the acquisition was fair. Although the appellants did not attend the meeting of shareholders held in May 1992, either personally or by proxy, they commenced litigation in the Supreme Court of New South Wales.[10]

The Litigation

The first hearing was before McLelland J. WCP led evidence that expropriation of the minority shareholders would enable the company to participate in substantial tax savings through the transfer of tax losses within the Industrial Equity group. These tax savings were estimated to be in excess of $4 million but would only be available if WCP was a wholly-owned subsidiary. Evidence was also led by WCP that the company would save approximately $3,000 per year in accountancy fees by not having to prepare group accounts and approximately $1,300 per year as the result of not needing to maintain a share registry service.

McLelland J held that the amendment was invalid because its immediate purpose and effect was to permit the shares of the minority shareholders to be expropriated by the majority. His Honour held that such an amendment amounted to "unjust oppression

9 Companies and Securities Advisory Committee, *Report by the Legal Committee on Compulsory Acquisitions*, January 1996.

10 Mr Gambotto has undertaken further legal action objecting to methods of compulsory acquisition of shares other than by an amendment of company articles. In *Gambotto v Resolute Samantha Ltd* (1995) 69 ALR 752, Mr Gambotto unsuccessfully challenged the constitutional validity of s 701 of the Corporations Law which provides for the compulsory acquisition of shares of dissenting offeree shareholders following a takeover.

of those minority shareholders who object".[11] This decision was reversed by the New South Wales Court of Appeal.[12] Meagher JA held that amendments to articles of association permitting expropriation of minority shares do not always constitute oppression of the minority. In the circumstances of the case before him, he noted that there would be considerable financial benefits for WCP if the expropriation were permitted. Given that the amount to be paid per share was fair, Meagher JA concluded that the amendment to the articles was valid. The other two judges of the Court of Appeal reached the same conclusion.

The High Court overruled the New South Wales Court of Appeal and held that the amendment to the articles of association of WCP was invalid. A joint judgment was delivered by Mason CJ and Brennan, Deane and Dawson JJ. McHugh J delivered a separate judgment agreeing with the result of the other judges. In their joint judgment, their Honours identified two categories of amendments to company articles:

* general amendments to articles of association; and
* amendments to allow expropriation by the majority of the shares of the minority or expropriation of valuable proprietary rights attaching to the shares.

With respect to the first category, the court stated that an alteration of the articles if regularly passed by a special resolution in accordance with the Corporations Law, will be valid unless it is *ultra vires* (ie, beyond any purpose contemplated by the articles) or oppressive.[13] With respect to the second category, the court stated that such an amendment must not only be for a proper purpose but it must also not operate oppressively in relation to the minority shareholders.

> The exercise of a power conferred by a company's constitution enabling the majority shareholders to expropriate the minority's shareholding for the purpose of agrandising the majority is valid if and only to the extent that the relevant provisions of the company's constitution so provide. The inclusion of such a power in a company's constitution at its incorporation is one thing. But it is another thing when a company's constitution is sought to be amended by an alteration of articles of association so as to confer upon the majority power to expropriate the shares of a minority. Such a power could not be taken or exercised simply for the purpose of agrandising the majority. In our view, such a power can be taken only if
>
> (i) it is exercisable for a proper purpose and
>
> (ii) its exercise will not operate oppressively in relation to minority shareholders.
>
> In other words, an expropriation may be justified where it is reasonably apprehended that the continued shareholding of the minority is detrimental to the

11 (1992) 8 ACSR 141 at 144
12 (1993) 30 NSWLR 385; 10 ACSR 468; 11 ACLC 457.
13 (1995) 182 CLR 432 at 444.

company, its undertaking or the conduct of its affairs - resulting in detriment to the interests of the existing shareholders generally - and expropriation is a reasonable means of eliminating or mitigating that detriment.[14]

In relation to determining whether an amendment to the articles is for a proper purpose, the court stated that an expropriation that has as its purpose the advancement of the interests of the company as a legal and commercial entity or those of the majority, even the great majority of the members of the company, is not one undertaken for a proper purpose. According to the court, "this approach does not attach sufficient weight to the proprietary nature of a share".[15] The court did state that an amendment would be for a proper purpose (provided it is not oppressive to the minority shareholders) where the substantial purpose is to secure the company from significant detriment or harm. Two examples were given by the court. First, expropriation is justified in the case of a shareholder who is competing with the company. Second, expropriation is also justified in order to ensure that the company can continue to comply with a regulatory regime governing the principal business which it carries on. The court gave the example of a company conducting the business of a television station and a renewal of the television licence being dependent upon the licensee's entire share capital being held by Australian residents. In this circumstance, the expropriation of foreign shareholders who are unwilling to sell their shares to Australian residents might be justified where the terms of the expropriation are not oppressive.

An amendment of the articles of a company which expropriates the shares of minority shareholders must not only be for a proper purpose, it must also not operate oppressively. The court stated that this means that the amendment must be fair in the circumstances. Fairness, according to the court, has both procedural and substantive elements. The procedural elements require the majority shareholders to disclose all relevant information leading to the alteration and also require the shares to be valued by an independent expert. The court left open whether procedural fairness also requires the majority shareholders to refrain from voting on the proposed amendment. The substantive element is that the terms of the expropriation must be fair. The court stated that an expropriation at less than market value is *prima facie* unfair and it would be unusual for a court to be satisfied that a price substantially above market value is not fair. However, the court stated that a shareholder's interest "cannot be valued solely by the current market value of the shares. Whether the price offered is fair depends on a variety of factors, including assets, market value, dividends and the nature of the corporation and its likely future".[16]

Finally, in relation to the onus of proof, the court held that the onus lies on those supporting the expropriation to show that it is a valid amendment.

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14 Ibid at 445.
15 Ibid at 446.
16 Ibid at 447.

Although McHugh J reached the same conclusion as the other four judges in holding the amendment to the articles invalid, his approach was somewhat different. He stated that a company may alter its articles to provide for expropriation of minority shareholders "only when the acquisition is necessary to protect or promote the interests of the company and when the alteration will not be oppressive to those shareholders".[17] He agreed with the other judges that expropriation may be permissible if it is necessary to protect the company against direct competition from a member or from a company of which the member is a director. He also stated that alteration for the purpose of expropriation may be permissible "if the character or status of a member will cause harm to the company or prevent it from pursuing a legitimate commercial interest".[18] Although administrative convenience or cost could never by itself justify an alteration for the purposes of expropriation according to McHugh J, an expropriation that would allow the company to reduce its potential tax liability is one that is commercially necessary to protect the assets of the company. Therefore, the amendment was one that was designed to protect or promote the interests of the company.

In reaching this conclusion, McHugh J differed from the other judges. However, he found the amendment invalid because it was oppressive. According to McHugh J, in order for an amendment to the articles not to be oppressive, those expropriating the shares will need to act fairly. Drawing upon the United States case *Weinberger v UOP Inc*,[19] his Honour stated that the concept of fairness has two basic aspects: fair dealing and fair price.[20]

In relation to determining whether a fair price is being made for the expropriation, McHugh J stated that while the market price of shares on a stock exchange is cogent evidence of value, it does not always equate to a fair price. Drawing upon *Weinberger*, his Honour noted that determining a fair price includes consideration of factors such as assets, market value, earnings, and future prospects of the company.[21] In an interesting observation on the pricing of shares on a stock exchange he further noted:

> No doubt in the long-term the share price of a company will reflect its fundamental earning capacity or value. But histories of stock markets are overrun by examples of companies whose intrinsic value remained unnoticed by the market for long periods of time. The "herd mentality" exists in the stock market as in other areas of life. Judges cannot delegate to the market the duties of courts to fix a fair price for shares.[22]

In relation to fair dealing, McHugh J stated that this requires the majority shareholders, through the company, to make full disclosure of all matters that may affect a judgment as to the fairness of the expropriation. More specifically:

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17 Ibid at 453.
18 Ibid at 455.
19 457A 2d 701 (1983).
20 (1995) 182 CLR 432 at 457.
21 Ibid.
22 Ibid at 458.

> This will usually mean the disclosure of the purpose of the transaction, the giving of full reasons for rejecting alternative means of achieving that purpose and for concluding that the compensation offered will be fair to those affected, and the obtaining of an independent valuation for the shareholders. In most cases, full disclosure will also require information concerning the current and historical market prices of the shares where they are applicable, the net book value of the assets, and the value of the company both as a going concern and on a liquidation together with any reports or appraisals prepared in relation to the alteration and any firm offers for, or serious inquiries about the purchase of, the assets of the company.[23]

Applying these principles to the facts of the case before him, McHugh J held that the principal goal sought to be achieved by the alteration of the articles was a legitimate business objective and one that would justify the expropriation given that it would enable the company to save over $4 million in taxes. However, the company had failed to prove that the expropriation was not oppressive. In particular, he stated that the evidence fell far short of proving that the company and the majority shareholders dealt with each of the appellants fairly. Consequently, he held the amendment to the articles to be invalid.

Key Aspects of Gambotto

There are a number of important aspects of the *Gambotto* decision. These are dealt with in detail in the various chapters of this book. Some of the more significant can be summarised. First, the High Court has placed new emphasis on the rights of minority shareholders and has carved out an important role for itself as a custodian of those rights. In particular, all of the judges of the High Court emphasised the need for majority shareholders to deal fairly with the minority in relation to expropriations. This includes the need to ensure that all relevant information is provided to minority shareholders but also the need to present independent and expert evidence that the price being paid to minority shareholders is fair. The court emphasised the proprietary nature of a share and has placed substantial hurdles before those who would expropriate the shares of a minority.

Second, the High Court introduced a new test for evaluating the validity of amendments to articles of association which provide for expropriation by the majority of the shares of a minority or of valuable proprietary rights attaching to the shares of a minority. In so doing, the court specifically rejected as inappropriate the "bona fide for the benefit of the company as a whole" test of Lindley MR in *Allen v Gold Reefs of West Africa Ltd*.[24] However, the court stated that the *Allen* test was inappropriate not only for amendments to articles involving an expropriation of shares but to any amendment to the articles of a company giving rise to a conflict of interests and advantages.[25]

23 Ibid at 459.

24 [1900] 1 Ch 656 at 671.

25 (1995) 182 CLR 432 at 444.

Third, the High Court held that in the case of an amendment to articles leading to expropriation, the onus lies on those supporting expropriation to show that the power is validly exercised. This represents a reversal of the previous situation. Fourth, the court emphasised the importance of adequate disclosure of all relevant information as part of ensuring that the amendment of the articles and subsequent expropriation is fair to the minority shareholders. Fifth, all of the judges stated that, when determining whether a fair price is being paid to minority shareholders, the court will not be guided solely by the market value of the shares but will consider other factors.

Sixth, the judgments in *Gambotto* have implications for other methods of expropriation such as expropriations following a takeover under s 701 of the Corporations Law and other expropriations regulated by s 414. In its submission to the Companies and Securities Advisory Committee recommending that limits be placed on the principles developed in *Gambotto*, the Law Council of Australia suggested that *Gambotto* has three major consequences for expropriations undertaken otherwise than by amendments to articles of association. The Law Council argued that the decision:

- imposes a "proper purpose" requirement in s 414 that does not currently exist
- reverses the onus on dissidents under ss 414 and 701
- introduces additional disclosure obligations in s 701.[26]

In its submission, the Law Council states that these consequences of *Gambotto* will create powerful new disincentives to takeovers and allow minority shareholders to employ the threat of protracted and uncertain litigation to extract an additional compulsory acquisition premium.[27]

The various methods of compulsory share acquisitions under Australian law are examined in detail in chapter 2. In this chapter Damian Grave provides an essential overview of these methods so that the reader can gain an appreciation of the potential implications of *Gambotto* for a range of methods of expropriation. The author gives most attention to ss 701-703 (applying to compulsory share acquisitions after a takeover offer or announcement) and s 414 (applying to all general takeover offers which are not regulated by chapter 6 of the Corporations Law). The author also considers selective reductions of capital and amendments to articles of association (as occurred in *Gambotto*) as methods of expropriation. The author concludes his chapter with a number of recommendations for reform.

In chapter 3 Professor Paul Redmond focuses upon disclosure obligations in situations of expropriation. He commences by examining disclosure obligations under the various methods of compulsory acquisition regulated by ss 701, 411 and 195. Professor Redmond then turns his attention to the disclosure requirements stipulated by the High Court in *Gambotto*. As part of his analysis, the author reviews disclosure obligations in relation to shareholder meetings, a topic that is increasingly important in

26 Supra n 9 at para 1.22.

27 Ibid at paras 1.21 and 1.24.

an era of heightened shareholder activism. Three key issues are then addressed by Professor Redmond. First, what is the precedential status of McHugh J's detailed statement of disclosure obligations? The author notes that some of the disclosure obligations outlined by McHugh J sit comfortably with existing law in the area of disclosure while others are less clearly supported by previous authority relating to disclosure. Second, the author considers some essential principles which underlie the disclosure requirements specified in *Gambotto*. Finally, the author considers the relationship between the disclosure requirements under the statutory methods of expropriation and the disclosure requirements stipulated in *Gambotto*.

Chapters 4 and 5 explore the implications of *Gambotto* for non-takeover aspects of compulsory acquisitions and for takeovers. In chapter 4 Quentin Digby focuses on selective capital reductions and demutualisations. The author notes that although the High Court in *Gambotto* chose not to refer to a recent line of selective capital reduction cases, despite their obvious relevance to the question before the court, *Gambotto* may still have implications for selective capital reductions under s 195. In particular, the Corporations Law simplification proposals which recommend the elimination of court confirmation for capital reductions will result in *Gambotto* becoming directly relevant to selective capital reductions. Turning to demutualisations, Mr Digby questions whether the view of a number of commentators that *Gambotto* eliminates any possibility of undertaking a demutualisation by means of an alteration to the articles, is correct. He argues that when a demutualisation is implemented by an amendment to the articles which results in all members losing their membership rights in exchange for the opportunity to receive shares in either the mutual company or a new holding company there is no conflict of interests and advantages which results in the application of *Gambotto*. All members are treated equally.

In chapter 5 Ian Renard comments on the implications of *Gambotto* for takeovers. In particular, he considers the ways in which the decision of the High Court increases the possibility of a minority shareholder resisting compulsory acquisition under ss 414 or 701 of the Corporations Law and also increases the possibility of an offeror having a target company restrictive article (designed to prevent a hostile takeover) declared invalid.

In chapter 6 Dr Elizabeth Boros considers the implications of *Gambotto* for minority shareholders. She focuses on three issues: the test to be applied when the validity of an alteration of company articles is challenged, whether interested shareholders can vote on a resolution to alter the articles, and the relationship between the common law and the statutory oppression remedy contained in s 260 of the Corporations Law. In answering the question whether interested shareholders can vote on a resolution to alter the articles (a question the High Court expressly left open in *Gambotto*) Dr Boros draws upon the law in other areas including ratification of directors' breach of duty, schemes of arrangement, class rights and reductions of capital.

While chapters 2 to 6 consider a number of practical implications of *Gambotto*, chapters 7 to 9 explore the theoretical dimensions of *Gambotto*. In chapter 7 Professor Deborah DeMott first describes how a *Gambotto*-like transaction would be structured under United States corporate law. She notes that, although the High Court in *Gambotto* draws upon the United States decision *Weinberger v UOP Inc*, the High Court judges impose substantive hurdles for expropriation that range well beyond the standards articulated in *Weinberger*. Professor DeMott then turns her attention to the different norms that underlie the High Court decision and US corporate law. She commences this section of her chapter by describing the difference between property rules and liability rules. Under a property rule, the holder of an entitlement has a veto over any proposed transfer of entitlement whereas under a liability rule a non-entitled party may purchase the entitlement at a price set by a court. Professor DeMott argues that this theoretical distinction applies to the treatment of expropriation or freeze-out transactions in Delaware law contrasted with *Gambotto*. Delaware applies a liability rule to these transactions in that the majority can compel the minority to sell subject to establishing that the transaction is fair to the minority. However, under the property rule utilised by the High Court in *Gambotto*, each shareholder has an absolute veto over the sale of his or her shares unless the majority establishes that the continuing ownership of the minority shareholder is detrimental to the company.

An economic analysis of *Gambotto* is provided by Michael Whincop in chapter 8. In the first part of this chapter, the author argues that the early development of the law relating to articles allowing for expropriation produced efficient and desirable outcomes. The author is critical of the judgments in *Gambotto* on a number of grounds including their potential to increase the "hold out" value of minority shares by discouraging expropriation at fair prices. This, according to the author, distorts the value of such shares and leads to inefficient allocation of investment. In the final chapter Saul Fridman criticises the focus of the High Court on property rights. According to the author, this is not an appropriate way to resolve the conflict presented by the facts of the case. The author recommends a statutory code for compulsory acquisitions based upon the provisions of the Ontario Business Corporations Act.

Law Reform Proposals

Several contributors to this book argue that legislative reform is warranted following *Gambotto*. A major concern is that some of the principles developed by the High Court have the potential to carry over into a number of areas of the law where the shares of minority shareholders are being compulsorily acquired. In January 1996 the Companies and Securities Advisory Committee recommended a series of reforms to accommodate some of these concerns.[28] An important recommendation of the Committee is to confine the decision in *Gambotto* to compulsory acquisitions or expropriations accomplished through amending articles of association. In particular, the Committee recommends

28 Supra n 9.

that ss 414 (if it is retained[29]) and 701 should be amended to put beyond doubt that:

* they are not subject to any "proper purpose" limitation
* the onus remains on dissidents
* no disclosure additional to Part A and Part C statements should be required under s 701

The Committee believes that this will achieve an appropriate balance between facilitating compulsory acquisitions (which are an appropriate and accepted feature of Australian commerce notwithstanding that they override the proprietary rights of individual shareholders) and the interests of all shareholders to avoid either minority oppression or minority dictation.[30] The Committee observes that compulsory acquisitions may produce considerable benefits including facilitating financial restructuring, permitting the transfer of tax losses between wholly-owned grouped companies, reducing administrative and reporting costs, avoiding greenmailing, and protecting the confidentiality of commercial information and otherwise eliminating possible conflicts of interest in partially-owned companies.[31]

Another recommendation of the Committee is to repeal s 414 and replace it with a new compulsory acquisition power involving a simplified procedure. It would not have the prerequisites of other compulsory acquisition powers such as s 701. The new compulsory acquisition power would permit a 90% full beneficial interest-holder of any class of securities (defined as a "controlling entity" in the report) to compulsorily acquire the remaining securities of that class. The procedure will require court approval of the offer price where a minimum number of remaining holders dissent. The key elements are:

* the controlling entity is able to make an unconditional cash offer to acquire all the remaining securities of a class
* the offer must be accompanied by at least one independent expert's report on whether it is for fair value
* the controlling entity must compulsorily acquire all the securities pursuant to the terms of the offer if fewer than 10%, by value, of the remaining holders' dissent
* the controlling entity must either withdraw the offer or seek a court order for compulsory acquisition pursuant to the terms of the offer if 10% or more, by value, of the remaining holders dissent

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29 The Committee recommends the replacement of s 401 with a new compulsory acquisition power. However, in the event that this recommendation is not accepted by the Government, the Committee recommends amendments to s 401.

30 Ibid at para 1.13.

31 Ibid at para 1.11.

* the court may only approve or not approve a compulsory acquisition for all remaining holders
* a controlling entity who compulsorily acquires the remaining securities of a particular class will also have to offer to buy out the holders of all securities convertible into that class.

Conclusion

These recommendations of the Companies and Securities Advisory Committee demonstrate the profound influence that *Gambotto* has had on corporate law in Australia. The importance of the decision lies both in its practical implications and also in the theoretical norms which underlie the judgments. Even if the reforms recommended by the Advisory Committee are enacted, *Gambotto* will continue to influence corporate law. Most directly, the Advisory Committee recommends that no changes be made to the principles developed by the High Court in *Gambotto* regulating compulsory acquisitions through amending articles of association. More broadly, principles developed by the High Court relating to the need to deal fairly with minority shareholders can be expected to influence other areas of corporate law. The High Court has carved out for itself a significant role in protecting minority shareholders and the scope of this protection will undoubtedly be developed in the course of subsequent judgments and future legislative reforms to the Corporations Law.

Part 2

Practical Implications of Gambotto

Chapter 2

Compulsory Share Acquisitions: Practical and Policy Considerations

Damian Grave[1]

Introduction

The 1926 Greene Committee (United Kingdom)[2] recommended that, where a scheme of amalgamation involving the transfer of shares or a class of shares has been approved by the holders of at least 90% of those shares, the offeror company should be allowed a short time in which to compulsorily acquire the remainder.[3] This recommendation was followed and a power of compulsory acquisition was introduced into the 1929 UK Companies Act. Successive UK Companies Acts contained similar provisions. Australian companies legislation also included a power of compulsory acquisition, and the present provisions are to be found in s 414 and ss 701-703 of the Corporations Law.[4] The evolution of Australian regulation of share acquisitions, following the recommendations of the Eggleston Committee,[5] has meant that ss 701-703 apply to compulsory share acquisitions after a takeover offer or announcement, and s 414 applies to all general takeover offers which are not regulated by Chapter 6 of the Corporations Law. Until recently[6] there had been very little analysis of the policy issues arising from the Australian compulsory share acquisition provisions. One of the consequences of this has been that the important balance between the interests of majority and minority members of a company have been allowed to be distorted at various stages of the acquisition process.[7]

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1 Solicitor, Freehill Hollingdale & Page. This is an updated version of an article which was published in (1994) 12 C&SLJ 240.

2 *Report of the Company Law Amendment Committee*, (1926) Cmnd 2657

3 Ibid at para 85

4 All section references will hereafter refer to provisions of the Corporations Law unless otherwise stated.

5 Company Law Advisory Committee. *Report to the Standing Committee of Attorneys-General on Disclosure of Substantial Shareholdings and Takeovers* (1969)

6 See W Kent and L Vary, "Compulsory Acquisition of Shares" (1991) 9 C&SLJ 261; Q Digby, "Eliminating Minority Shareholdings" (1992) 10 C&SLJ 105; P Spender, "Compulsory Acquisition of Minority Shareholdings" (1993) 11 C&SLJ 83; Legal Committee of the Companies and Securities Advisory Committee, "Compulsory Acquisitions, Issues Paper" (March 1994), "Compulsory Acquisitions, Reform Proposal" (November 1994) and "Report on Compulsory Acquisitions" (January 1996).

7 Spender, ibid at 84, after noting the difficulties facing a minority in resisting acquisition once the 90% threshold has been obtained, says "considering that the obligation of the judiciary and the legislature is to balance the rights of the minority shareholders and the bidder, it may be that the pendulum has swung too far in favour of the bidder".

For example, it has been said that the procedural threshold requirements for an offeror are relatively onerous and cumbersome[8] and may provide some scope for the apathetic shareholder to thwart an acquisition.[9] This may explain the recent increase in the use of alternative methods to acquire the shares of minority shareholders.[10] All involve a lower threshold than presently exist under the compulsory share acquisition provisions. Although reform appears necessary, the method by which such reform should proceed has attracted a variety of opinions.[11] If there continues to be a power of compulsory acquisition, and the present legislative structure remains in place, it will be important for there to be a critical review of existing provisions. This will necessitate a careful consideration of s 701 (not only the acquisition thresholds where most attention has focussed) and also a coordinated analysis involving s 414, ss 701-703 and the alternative methods of acquisition. With this in mind, the purpose of this chapter is to (i) detail the operation of the compulsory acquisition provisions, identify some of the problems and suggest possible areas for reform and (ii) outline recent developments in the use of alternative methods to acquire the shares of minority shareholders.

Reasons for Total Control

In small private or quasi-partnership type companies, where it is not uncommon for directors to be the sole shareholders, any moves by a majority can usually be attributed

8 Digby, supra n 6 makes repeated references to this at 106, 110, 115, 128 and 129.

9 See Digby, supra n 6 at 109.

10 See generally *Nicron Resources Ltd v Catto and Others* (1992) 8 ACSR 219 per Bryson J (court confirmation of selective capital reduction); *Re ACM Gold Ltd; Re Mt. Leyshon Gold Mines Ltd* (1992) 7 ACSR 23 (court confirmation of scheme of arrangement); *Gambotto v WCP Ltd* (1992) 8 ACSR 141 (SC(NSW)), *WCP Ltd v Gambotto* (1993) 10 ACSR 468 (CA(NSW)), *Gambotto v WCP Ltd* (1995) 182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243 (HC) (alteration of articles of association to acquire minority held shares); Submission by ASC to Inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs into Corporate Practices and the Rights of Shareholders (Dec 1990) at 117-121.

11 Digby, supra n 6 at 129-130 suggests that reform is best achieved by enhancing an offeror's ability to acquire minority held shares and ensuring both the fairness of an offer and the disclosure of all facts relevant to the offer's fairness. In particular, if "minority approval is to be a procedural requirement, it should be a simple majority of those minority members who are sufficiently interested to vote or to otherwise demonstrate their approval or disapproval". (at 130) In contrast, the Lavarch Committee, *Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs*, "Corporate Practices and the Rights of Shareholders" (Lavarch Chairman 1991) at 80 has recommended that the s 414 and s 701 acquisition thresholds and their calculations be assimilated and the use of alternative methods to acquire minority held shares on unfair terms be restricted. Spender, supra n 6 has advocated a more wide-ranging reform to be directed at the nature of compulsory share acquisition itself and remedying the perceived distortion favouring offerors over minority shareholders. To this end, Spender at 101 says "it may be feasible for the onus of proof to be reversed, so that the majority must prove that the acquisition is fair or that unfairness is assessed in relation to the circumstances of the individual shareholder". Also, see generally the approach proposed by the Legal Committee of the Companies and Securities Advisory Committee, supra n 6, "Report on Compulsory Acquisitions" (January 1996).

to dissension among members.[12] With larger companies, where the number of shareholders and constraints of financial resources usually mean that the emphasis moves from 'insiders' to 'outsiders' seeking control,[13] total control is frequently desirable to consolidate the economic purpose and to facilitate a process of rationalisation.[14] In addition, the tax advantages that may be available by transferring tax losses within a "group" of companies pursuant to s 80 G of the Income Tax Assessment Act (Cth) will be very attractive. However, "group" status will be denied where there is a failure to meet the 100% common ownership test for the duration of the relevant period.[15] This has meant that where a company has issued convertible notes or options over unissued shares, and these either remain unexercised or are converted during the year of income, an otherwise wholly-owned subsidiary is prevented from transferring or receiving tax losses to be deductible against assessable income. This problem received widespread publicity in the 1989 battle for Humes Ltd where it was alleged that the Smorgan Group of companies would lose a potential $28m tax benefit if convertible noteholders in Humes Ltd exercised their conversion rights.[16]

Majority Initiated Acquisition

Operation

Section 701 allows an offeror to compulsorily acquire the outstanding shares of dissenting offeree shareholders (subject to "the 75% requirement") where the offeror has become entitled to at least 90% of the class of shares bid for. The bid *must* have taken the form of a takeover announcement *or* an offer made for *all* the shares in the relevant class of shares held by the offeree in the target company ("full takeover

12 This dissension may arise for a number of reasons, some of which include, (a) the acquisition of a competing business by a minority shareholder and the subsequent use of company resources to benefit the newly acquired business, (b) unreasonable and unco-operative participation, and (c) the treatment of corporate status as a partnership or family business resulting in attempts to use corporate assets interchangeably with family members and partners personal assets. See generally F H O'Neal and R Thompson, *O'Neal's Oppression of Minority Shareholders* (Clark, Boardman and Callaghan, 2nd edn, 1993) at Chapter 2.

13 The main exception is management buy-outs (MBO's) where management ('insiders') acquire all or a dominant interest in a company.

14 Lavarch Committee, supra n 11 at 74 (para 3.4.2). Also see G K Yarrow, "Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process" (1985) 34 J of Ind Eco 3 at 4 who is concerned with what he describes as the free-rider problem. Improved company performance following a takeover benefits all shareholders. No-one can be excluded without buying them all out, and, if each expects that the 'good' will continue, they will have no incentive to sell their shares on terms that would allow a raider to make a positive profit once the transactions costs of the bid are taken into account. Yarrow believes that compulsory acquisition rights can solve the free-rider problem in the presence of strong protection for minority interests.

15 See generally Taxation Ruling IT 2465.

16 See *ANZ Executors and Trustees Limited and PS Enterprises Nominees Pty Ltd v Humes Ltd and International Pacific Holdings Ltd* (1989) 15 ACLR 392. Other reasons for total control are detailed by Digby, supra n 6 at 107-108 and I A Renard and J G Santamaria, *Takeovers and Reconstructions in Australia* (Butterworths, 1990) at 12,011.

scheme").[17] If a takeover announcement is not made, or offers under a full takeover scheme are not dispatched, s 701 will be inapplicable. An offeror initiates the process of compulsory acquisition by giving the prescribed notice to a dissenting offeree before the end of two months *after* the end of the offer period.[18] In *Elkington v Vockbay Pty Ltd*[19] it was submitted that this wording enabled immediate dispatch once the s 701 requirements had been fulfilled.[20] To this, Owen J said.

> I have difficulties with this submission. In my opinion it runs counter to the general scheme of the legislation which affords protection to shareholders by ensuring that they have sufficient information on which to make a decision and adequate time within which to do so. It would, in my view, be inimical to those principles to allow the offeror, without intervention from the regulatory authority, to truncate time periods apparently set for the protection of the shareholder.[21]

Although these are important considerations, it should be emphasised that, unless the takeover offers remain subject to conditions, an offeror effectively obtains an entitlement to acquire the outstanding shares of dissenting offeree shareholders once the s 701 requirements have been fulfilled. An acquisition notice should, subject to the conditions point above, be able to be dispatched at this time. Shareholders could be protected by allowing further time in which to request a written statement of the names and addresses of dissenting offerees and to make the Court application.

To use s 701, an offeror must have 'become' entitled (pursuant to the takeover scheme, announcement or otherwise) to at least 90% of the shares in the relevant class of shares during the "takeover period". This is the period between the date of service of the Part A statement on the target, *or* the time of making the takeover announcement, and the end of the relevant offer period (or, if offers under a full takeover scheme are *not* sent before the end of 28 days after the day the Part A statement was served, the end of those 28 days).[22] If an offeror is already entitled to at least 90% of the shares at the time of service of the Part A statement or date of announcement, and still desires to proceed to compulsory acquisition, the offeror can use s 414 but, strangely, not s 701

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17 Section 701(2)(a). "Full Takeover Scheme" is defined in s 603 to mean a takeover scheme under which each takeover offer relates to *all* the shares in the target company in the relevant class that the offeree holds.

18 Section 702(2). This notice needs to be lodged with the ASC: s 701(4).

19 (1993) 10 ACSR 785.

20 Under ss 42(2) and 42(3) of the Companies (Acquisition of Shares) Code ("CASA") the prescribed notice could only be dispatched 'within' one month *after* the last day upon which takeover offers made under a takeover scheme or constituted by a takeover announcement remained open. Clearly, this meant that the relevant notice could not be dispatched until after the offer period had closed. The change in terminology to 'before' rather than 'within' may support Counsel's submission. However, it is not clear that such a change was intended or, in fact, that it would be a correct interpretation. It is implicit that only when a takeover period has closed can an offeree become a *dissenting* offeree and eligible to receive a s 701(2) notice.

21 Supra n 19 at 800.

22 Section 603.

Provided the 90% entitlement has been obtained during the takeover period, an offeror may proceed to compulsory acquisition even if there is a subsequent share issue by the target corporation which causes the offeror's entitlement to fall below 90%.[23] However, the offeror will only be permitted to acquire the newly issued shares if they are "outstanding shares". "Outstanding shares" are shares in respect of which offers were made and (i) which the offeror was not entitled at the time the first of the offers was made and (ii) which have not been subsequently acquired by the offeror pursuant to the offer or otherwise.[24] The ASC has provided some guidance on what constitutes shares in respect of which offers were made.[25]

The 75% requirement

If less than 90% of the class of shares bid for were "subject to acquisition" by the offeror pursuant to the scheme or announcement, a further condition must be met.[26] "Shares subject to acquisition" are shares in respect of which offers were made, other than shares to which the offeror was entitled when the first of the offers was made.[27]

A compulsory acquisition is only possible if:

(i) three quarters of the offerees have disposed of the shares subject to acquisition held by them to the offeror, whether by acceptances pursuant to the scheme (or announcement, as the case may be) or otherwise (s 701(2)(c)(i)); or

(ii) at least three quarters of the persons, who were registered as the holders of shares in that class before the Part A statement was served or takeover announcement made, are not so registered one month after the end of the offer period (s 701(2)(c)(ii)).

Joint holders of shares are treated as being a single holder.[28] Also it would seem that only those offerees who have disposed of *all* of their shares to which the offer relates [s 701(2)(c)(i)], *or* are no longer registered with respect to *any* shares

23 Section 701(2)(b).

24 Section 701(1)(c).

25 In the case of a takeover scheme, shares may be issued after the Part A statement has been served and *either* before or after offers are dispatched. If shares are issued *before* offers are dispatched, the ASC takes the view that the offeror must extend offers to all target company shareholders as at the date the offers are dispatched with respect to all shares held at that time. (ASC Practice Note 6.3.2 "Shares to Which Takeover Offers Must Relate" at paras 8-13). If shares are issued *after* offers are dispatched, the ASC takes the view that offers need not extend to those shares. (ASC Practice Note above at paras 6 and 7.) However, the ASC may, in appropriate cases, permit a modification to the Law to allow an offeror to extend offers to include those shares. The ASC (at para 7) only makes mention of shares issued by the target company as a result of the exercise of options or conversion of securities which were issued before the offers were made. Presumably, a modification will also be possible for shares issued otherwise than by the exercise of options or conversion of securities.

26 In other words, if, at the time when the first of the offers was made, the offeror is entitled to more than 10% of the shares in respect of which offers were made, a further condition must be met.

27 Sections 701(1)(a) and 701(1)(b).

28 Section 701(3).

[s 701(2)(c)(ii)], will be regarded as accepting offerees.

In addition, it appears that the s 701(2)(c) requirements may be fulfilled at *any* time prior to the s 701(2) notice being given. In *Brierley and Anor v Dextran Pty Ltd & Ors*[29] Tadgell J, in considering the relationship between paragraphs (a) and (b) of s 42(2) of CASA, said:

> ...each of the above conditions specified by paragraphs (a) and (b) is arbitrary and it is not necessarily illogical that a greater or different period for the satisfaction of the latter should be allowed than for the satisfaction of the former, given that they deal with different concepts, and given also that sometimes paragraph (b) might not have to be satisfied at all. Counsel for the plaintiff submitted that a "dissenting offeree" to whom a notice under s 42 [CL s 701] is to be given must be capable of ascertainment as such at the end of the period during which offers remain open. I agree. But if a shareholder, being an dissenting offeree by definition at the time offers expire, later disposes of his shares to the offeror before the expiry of the month during which notices may be given, it does not seem to be logically objectionable to count him among the offerees for the purposes of paragraph (b).[30]

Even if paragraph (b) does need to be satisfied before the end of the offer period, the fact that the NCSC had, in *Brierley*,[31] extended the time for compliance with paragraph (a) meant that there was a corresponding extension for compliance with paragraph (b).

The requirement in s 701(2)(c)(i) (number of shareholders disposing of shares to the offeror) existed under s 42(2)(b) of CASA, whereas the requirement in s 701(2)(c)(ii) (number of shareholders selling out) was introduced into the Corporations Law after much discussion. The Edwards Committee[32] noted that the requirement in s 42(2)(b) of CASA was ambiguous and difficult to apply in circumstances where a target was listed, and where there was extensive market activity in its shares during the course of the takeover bid. The NCSC and now the ASC have provided guidelines on this matter.[33] However, it was anticipated that the alternative provided by s 701(2)(c)(ii) would not materially alter the nature of the obligation, but would help resolve the difficulties presented in calculating the level of acceptances. Despite this, there still exist a number of problems with the operation of the 75% requirement:

(i) Where minorities are represented by trustees in the case of deceased estates (who may not have the power to sell), some shareholders cannot be traced, or, where there are simply a large number apathetic

29 (1990) 3 ACSR 455.

30 Ibid at 463-464.

31 Supra n 29.

32 *Report of the Joint Select Committee on the Corporations Legislation*, (1989) at paras 13.33 and 13.43.

33 See NCSC Policy Statement: Compulsory Acquisition of Shares (Release 139) at para 5 and ASC Policy Statement 98: Compulsory Acquisition (issued 7 August 1995 and supersedes NCSC Release 139) at paras 13-16.

shareholders, compliance with the 75% requirement may prove extremely difficult. In the UK, s 430C(5) of the Companies Act permits an offeror to seek a court order to dispatch the relevant notices in circumstances where, after reasonable enquiry, one or more shareholders cannot be contacted. The requirement is that the shares held by these persons, together with existing acquisitions, amount to not less than the threshold *and* that the consideration is fair and reasonable. The court will not make the order unless it considers it just and equitable to do so. The ASC has indicated a willingness to tackle this issue by modifying the Law upon compliance with specified requirements.[34]

(ii) "Share-Splitting" involves the transfer of shares held by either non-associates of the offeror (to thwart compliance with the compulsory acquisition thresholds), or associates of the offeror (to facilitate compliance with the compulsory acquisition thresholds). Where a 'split' contains an element of obvious artifice, the ASC might intervene. Under s 701(2)(c)(i), the requirement that three quarters of the offerees have disposed of to the offeror the "shares subject to acquisition" that were held by them, prevents a 'split' by associates of the offeror to other associates to facilitate compliance with the compulsory acquisition thresholds. But it is still possible for a 'split' by non-associates of the offeror to other non-associates to be used to thwart compliance. In contrast, s 701(2)(c)(ii) makes no mention of "shares subject to acquisition". This would seem to encourage share transfers from an offeror to associates, and between associates, prior to the service of the Part A statement (and for such transfers to be registered prior to service of the Part A statement) in order to enhance the prospects of complying with s 701.[35]

Given these difficulties with the 75% requirement, it is unclear why it was incorporated into Australian legislation. The 75% requirement was introduced into UK law following the recommendations of the Cohen Committee on Company Law.[36] That Committee thought it anomalous that compulsory acquisition was not available in circumstances where an offeror held 10% or more of the shares prior to a bid.[37] The

34 Ibid at paras 20-22 which details the relevant factors the Commission will consider in determining whether to exercise its discretion. Where the Commission may be disposed to modify the Law, the offeror will be required to make extensive enquiries (see ibid paras 24-27 and the NCSC Submission noted in the Edwards Committee Report, supra n 32 at para 13.39).

35 See Kent and Vary, supra n 6 at 264. Alternatively, an offeror who has acquired shares prior to the service of the Part A statement, may delay submission of the share transfer forms for registration until after the Part A statement has been dispatched in order to enhance the prospects of compliance with the provisions. Similarly, Renard and Santamaria, supra n 16 at 12015 recognise that an opponent to the bid may purchase target company shares but delay registration in order to disguise the extent of turnover in member's registration during the offer period.

36 *Report of the Committee on Company Law Amendment*, (1945) Cmnd 6659.

37 Ibid at para 141.

legislation did not contain an express prohibition and any restriction that existed must have been implied from the wording of the then s 155 of the 1929 UK Companies Act. Section 155 required approval by the ". . . holders of not less than nine-tenths in value of the shares affected . . ." .This must have been interpreted to mean that an offeror needed to receive acceptances from the holders of nine-tenths in value of all the shares on issue and, if an offeror initially held 10% or more of these shares, this was obviously impossible. However, a plain and commercially sensible reading of the section ("the shares *affected* ...") could have avoided the problem. The shares affected are all the shares on issue other than those held by the offeror at the time of the offer.[38]

Despite this interpretation, it is still difficult to understand why the legislation was amended in the manner that it was. In *Brierley,*[39] Tadgell J said that it "seems to be designed to ensure that, before a compulsory acquisition of outstanding shares can occur, there should be a reasonable spread of shareholders, being offerees, who have disposed of their shares to the offeror".[40] Kolodny[41] acknowledges that such a requirement makes compulsory acquisition more difficult and says it "sets up a double-barrelled means of ensuring that the approval is independently obtained". These reasons are not convincing. The 1962 Jenkins Committee[42] could see no reason for the extra requirements and recommended its repeal. Similarly, the 1984 Law Society Standing Committee on Company Law stated that "there seems no logic in making the compulsory acquisition more difficult in these circumstances."[43] The 75% requirement was removed from the UK Companies Act after amendments introduced by the 1986 UK Financial Services Act.

A reasonable balance between majority and minority can be achieved, and independence of approval obtained, if the power of compulsory acquisition was made dependent upon the offeror acquiring 90% of the "shares subject to acquisition". Some modification of the definition of "shares subject to acquisition" may be needed to prevent persons purchasing shares on-market after the Part A statement is served and before the first offers are dispatched for the sole purpose of blocking a bid or forcing an increase in the offer consideration. The obligation could be to acquire 90% of the shares to which offers relate, excluding any to which the offeror was entitled at the time the Part A statement was served or the takeover announcement was made. In addition, the offeree could be given a right to apply to the Court (in similar terms to that which exists in the UK) where untraceable shareholders prevent the attainment of the requisite percentage. This right could co-exist with the ASC's power of modification.

38 See McLelland CJ in *Lewis Emanuel & Son Limited v Lombard Australia Limited and Lombard Banking Limited* [1963] NSWR 38 at 40 where he said that "nine-tenths in value is nine-tenths of the value of all the shares in the company other than the shares already held at the time of the offer by the company making the offer". A similar view was expressed by Coady J in *Rathie v Montreal Trust Company* [1952] 3 DLR 61 at 67.

39 Supra n 29.

40 Ibid at 463.

41 K Kolodny, "Protection of Minority Shareholders After a Takeover Bid" (1986) 7 Co Law 17 at 18.

42 *Report of the Company Law Committee* (1962) Cmnd 1749 at para 288.

43 *Memorandum by Law Society's Standing Committee on Company Law*, 1984 at para 21.

Share transfers

A s 701(2) notice is given by an eligible offeror to a "dissenting offeree".[44] A "dissenting offeree" is defined in relation to shares to which an offer or announcement has been made as a person who is the *holder* of "outstanding shares".[45] The term does not include a person who only has a right to be registered as the holder of shares. Further, "outstanding shares" do not include shares in respect of which the offeror was entitled at the time when the first of the offers was made. It is possible, therefore, that an offeror may not actually become registered as the holder of *all* the shares in the target company following a s 701 compulsory acquisition.

It may be thought that an offeror will have problems in effecting a compulsory acquisition where shares are transferred during the offer period to persons who do not become registered as the holders of shares. These transferees will not be 'dissenting offerees'. However, the share transferors will be 'dissenting offerees' and an offeror may dispatch an acquisition notice to such transferors. Although the transferees will have the beneficial entitlement to the relevant shares, s 701(5) entitles the offeror to acquire the shares to which the notice relates. The offeror will then transfer the required offer consideration to the target company who will hold it for the former holder of the shares. It may be worthwhile to include a provision like s 414(14) which requires it to be held by the company for those persons entitled[46] to the relevant shares.

Court applications

The Court has power to prevent a compulsory acquisition. A dissenting offeree may request the offeror to provide a written statement of the names and addresses of all dissenting offerees before the end of one month after the s 701(2) notice is given.[47]

This ensures that dissenting offerees have an opportunity to make enquiries with a view, for example, to sharing any costs involved in making the relevant Court application. A dissenting offeree, who has sought the above statement, has 14 days from the date of receipt to make the Court application.[48] In other cases, the application must be made within one month from the time the s 701(2) notice was given.[49]

1 Nature of discretion

Although the Court may prevent a compulsory acquisition outright, it is unclear

44 Section 701(2).

45 Section 701(1)(d).

46 "Entitled" will not have its technical Chapter 6 meaning. In this context it will have its ordinary meaning and should include unregistered share transferees during the offer period.

47 Section 701(9).

48 Section 701(6)(b).

49 Section 701(6)(a). In *Re New Zealand Ski Fields Limited* [1991] 5 NZCLC 67376 Anderson J held that an application is 'made' when it is filed. There is not a requirement for the application to also have been served for it to be regarded as 'made'. A court still has jurisdiction to entertain a court application in circumstances where the relevant notice was filed but the offeror was not served within the prescribed time.

whether it can vary the terms of acquisition. Section 701(5) provides that once a s 701(2) notice is given, the offeror is entitled and bound to acquire the relevant shares on the terms which exist at the end of the offer period. Section 701(6) provides that the Court may order that s 701(5) does not apply in relation to a dissenting offeree. It could be argued that s 701(5) *applies* to both the acquisition of shares *and* the terms upon which that acquisition is to take place. The discretion need not be limited to either of the above to the exclusion of the other. It may extend to making orders affecting the offeror's right and obligation to acquire the relevant shares and also the terms upon which that acquisition is to take place. Despite this interpretation, it appears to have been assumed that the discretion is limited, and that the Court may only prevent compulsory acquisition outright.[50]

This restrictive view has been questioned by Henry J in *Plaza Fabrics (Tauranga) Ltd v National Airlines Co. Limited*[51] when considering the corresponding provisions of the 1955 New Zealand Companies Act. He said that:

> Under subs(1) the offeror can acquire and the shareholder can apply to the Court to prevent the acquisition or to fix its terms. I do not think that subs(1) restricts the Court's intervention to merely prohibiting the acquisition, and I respectfully agree with the observation of Hardie Boys J in *Re Deans* [1986] 2 NZLR 271 at 278 that the Court can do more than simply allow or disallow the objection, and may impose terms.[52]

The New Zealand legislation on this issue is identical in all material respects with the discretion conferred on the Court pursuant to s 414(3). Although the wording used in s 701(6) is couched in different terms to its NZ counterpart, it is pertinent to note that Henry J, in *Plaza Fabrics*,[53] obtained further support for this wider discretion by considering the relationship between the NZ equivalents of s 701(2) and s 703. Under s 703, where a shareholder exercises the right to require the offeror to acquire its shares, the terms of acquisition will be those under the offer, as agreed, or as the

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50 In *Elkington v Shell Australia Ltd* (1992) 10 ACSR 568 (SC(NSW)) and (1993) 11 ACSR 583 (CA(NSW)), the issue was not discussed as the Court application was to prevent the outright acquisition of minority held shares. But, in the context of s 42(7) of CASA [predecessor to s 701(2)], Bryson J in *Kingston and Anor v Keprose Pty Ltd (No. 2)* (1988) 6 ACLC 111 at 116 said that:

> ..... s 42 of the Code, which relates to the compulsory acquisitions, seems to make the terms of the offer the only available terms on which the compulsory acquisition is to take place, to be escaped from only under s 42(7) and only by obtaining a court order defeating compulsory acquisition itself.

Under legislation equivalent to s 414 see *Re Hoare & Co Ltd* (1933) 150 LT 374 at 374 per Lord Maugham; *Kinross v Heritable Securities & Mortgage Investment Co* (1935) SN 25 per Lord Carmont; *Re Evertite Locknuts Ltd* [1945] Ch 220 at 222 and *Re Sussex Brick Co Ltd* [1961] Ch 289 at 290 where Vaisey J in each case approved the comments of Lord Maugham in *Re Hoare and Co Ltd; Nidditch v Calico Printers Association (1961)* SLT 282 at 286 per Lord President Clyde and at 287 per Lord Guthrie; *Re Fraser Hinde & Sons Ltd* The Times 23 April 1966 per Pennycuick J; *Cockle v Carlingford Nominees Ltd & Anor* (1989) 4 NZCLC 65,120 per Barker J

51 [1992] 1 NZLR 584.

52 Ibid at 588. *Re Deans; Re Stevens Group Properties Ltd* may also be found in (1986) 3 NZCLC 99,620.

53 Supra n 51 at 588.

Court may determine on the application of either party. It is possible for a s 701(2) notice to be dispatched after the dispatch of a s 703 notice. In such cases, the rights of a shareholder under s 703 will coexist with the rights of an offeror under s 701. From a policy viewpoint, the ability of the Court to vary the terms of acquisition should not depend on whether the right of compulsory acquisition is initiated by an offeror or a dissenting shareholder. The power of the Court to vary the terms of acquisition should be made explicit.

2 *Burden of proof*

The burden of proof usually rests on a dissenting shareholder. In *Re Hoare*[54] Lord Maugham, after considering the terms of s 155 of the UK Companies Act 1929, said that:

> .... it is manifest that the reasons for inducing the Court to 'order otherwise' are reasons which must be supplied by the dissentients who take the step of making an application to the Court, and that the onus is on them of giving a reason why their shares should not be acquired by the transferee company.[55]

Further, in *Re Sussex Brick Co Ltd*[56] Vaisey J said that:

> I think that the applicant is faced with the very difficult task of discharging an onus which is undoubtedly the heavy one of showing that he, being the only man in the regiment out of step, is the only man whose views ought to prevail.[57]

The situation is different where the persons who accepted the offer are not independent of the offeror. This allegation is more likely to arise in the context of s 414, than s 701, as the latter provision incorporates the wide concepts of an "entitlement to shares" and "shares subject to acquisition". In *Re Bugle Press Ltd*[58] J and S between them held 90% of the issued share capital of Bugle Press Ltd. The remaining 10% was held by T. J and S promoted a company called J and S (Holdings) Ltd of which they were the only shareholders and directors. J and S (Holdings) Ltd made an offer to purchase all the issued share capital of Bugle Press Ltd and received acceptances from J and S for all the shares they held in Bugle Press Ltd. The remaining shareholder (T) in Bugle Press Ltd sought a court order to prevent compulsory acquisition. Of course, the offeror argued that there had been strict compliance with the relevant UK legislation; J and S were not nominees or subsidiaries of J and S (Holdings) Ltd. However, there was no doubt that, in substance, the offeror was 'controlled' by J and S and it was their acceptance which made it possible to proceed to compulsory acquisition. Buckley J, at first instance, said that the burden of proof was reversed. The offeror had the onus of proving that the price offered was fair, which, on the facts, it was unable to discharge.[59]

54 Supra n 50.
55 Ibid at 375.
56 Supra n 50.
57 Ibid at 291.
58 [1961] Ch 270.
59 Ibid at 278.

On appeal, Lord Evershed (with whom Harman and Donovan LJJ agreed) adopted a slightly different approach. Lord Evershed said that where the applicant could show that there was a coincidence of identity between the offeror and the 90% whose acceptance made it possible to proceed to compulsory acquisition, the applicant would have made out a case for a court order.[60] In those circumstances, it is then up to the offeror to establish that there was some good reason in the interests of the company why the acquisition should still proceed. Lord Evershed considered that, if the offeror could show that the minority "was in some way acting in a manner destructive or highly damaging to the interests of the company from some motives entirely of its own",[61] this may be sufficient. The fact that the terms offered are fair may not be enough. A very similar fact situation to that in *Re Bugle Press Ltd*[62] arose in *Re Rees' Application*[63] where Hoare J quoted with approval the comments of Buckley J in *Re Bugle Press Ltd*.[64] Hoare J held that where a majority of members of one company have a major shareholding in another company, and then use that other company to take over the shares of the former, the onus of proving the fairness of the offer will be on the offeror.

It may not matter which of the above approaches to the burden of proof is adopted. They may both lead to the same result. The real difficulty will be to know when the lack of independence between the offeror and the shareholders who accepted the offer will be sufficiently great to shift the burden of proof. Hoare J, in *Re Rees' Application*,[65] acknowledged the problem but did not provide an answer. He simply said that there will be many cases where the grounds of suspicion will be insufficient to change the usual onus of proof.[66] It will ultimately be a question of fact.

3 *Unfairness*

Since the legislature has not provided any guidance as to when an order may be made, the courts, in exercising their discretion, have focused on whether the scheme or offer is "fair".[67] This formulation is not very helpful. It is possible for every applicant to argue that, in a subjective way, the scheme or offer was unfair. Faced with this problem the courts have said that unfairness relates to the shareholders as a whole and

60 Ibid at 286-287.

61 Ibid at 287.

62 Supra n 58.

63 [1972] QWN 47. Consider *Coleman v Myers* [1977] 2 NZLR 225 and also *Esso Standard (Inter-America) Inc v JW Enterprises et al and MA Morrisroe* (1963) 37 DLR (2nd) 598 where the Supreme Court of Canada expressly approved *Re Bugle Press Ltd*, supra n 58.

64 Supra n 58.

65 Supra n 63.

66 Ibid at 113.

67 For examples, see *Re Hoare*, supra n 50 at 375 per Lord Maugham; *Re Evertite Locknuts Ltd*, supra n 50 at 222-224 per Vaisey J; *Re Press Caps Ltd* [1949] Ch 434 at 440 per Somervell LJ and at 446 per Wynn-Parry J; *Re Sussex Brick Co Ltd*, supra n 50 at 290 per Vaisey J; *Re Deans*, supra n 52 at 99,622 per Hardie Boys J; *Re Sheldon*; *Re Whitcoulls Group Ltd* (1987) 3 NZCLC 100,058 at 100,059 per Holland J; *Cockle v Carlingford Nominees Ltd & Anor*, supra n 50 at 65124-65125 per Barker J; *Elkington v Vockbay Pty Ltd*, supra n 19 at 793-799.

not to the applicant's individual circumstances. In *Re Grierson, Oldham and Adams Ltd*[68] Plowman J said that the "test of fairness is whether the offer is fair to the offerees as a body and not whether it is fair to a particular shareholder in the peculiar circumstances of his own case".[69] This has led Beck[70] to point out that the minority are, by definition, small in number, and it is practically inconceivable that such a small group of shareholders could ever demonstrate that a scheme is unfair to the shareholders as a *whole*. Exceptional circumstances will be required before a court will interfere with the approval by holders of 90% of the relevant class of shares. Vaisey J in *Re Sussex Brick Co Ltd*[71] suggests that the unfairness will need to be obvious or patent although, as Hardie-Boys J said in *Re Deans*,[72] an applicant need not show that the shareholders who accepted the offer were "morons".[73]

Very few applications by dissenting shareholders have been successful. In *Elkington v Shell Australia Ltd*,[74] the New South Wales Court of Appeal has affirmed that the listed or quoted price of shares in a stock exchange listed company is usually taken to be a satisfactory indication of their value. Sheller JA (with whom Meagher JA agreed) said:

> The question here is whether a compulsory acquisition for shares at a price considerably higher than the shareholder would have received for them immediately before the takeover had he sought to sell them on the open market is unfair. To my mind it was not and his Honour was not bound to hold that it was because Rothschild in a report prepared to accompany the Part B statement thought otherwise. His Honour was entitled to prefer the evidence of the market place to the evidence of the report of Rothschild however bona fide it may have been.
>
> ...
>
> I do not think it was unreasonable for his Honour not to accept the opinion of Rothschild. The report was replete with imponderables and uncertainties and while it is true that valuations inherently may include elements of uncertainty that only emphasises that usually the price in a free market is a fairer guide. Had the authors of the Rothschild report adjusted the market price to allow for what they called the limited liquidity in the market their opinion might, in my view, have carried greater weight. Instead they abandoned the market price in favour of a method of valuation of far less certainty and to my mind remote from the true value of the shares namely what a purchaser in the market place would pay for them.[75]

68 [1968] Ch 17.
69 Ibid at 32.
70 (1986) NZLJ 335 at 336.
71 Supra n 50 at 292.
72 Supra n 52.
73 Ibid at 99, 623.
74 Supra n 50. Also see *Re press Caps Ltd*, supra n 67 at 447 per Wynn-Parry J; *Re Sussex Brick Co Ltd*, supra n 50 at 292 per Vaisey J; *Re Grierson*, supra n 68 at 32 per Plowman J; *Re Sheldon*, supra n 67 at 100,059-100,060 per Holland J.
75 *CA (NSW)*, supra n 50 at 593.

However, as alluded to by Sheller JA, the market price may not be an accurate measure of their true worth. There may be a 'thin' trading market or some exceptional circumstance may operate to depress the price. In *Mercantile Mutual Life Insurance Co Ltd & Ors v Actraint No. 85 Pty Ltd (No. 2)*[76] Jacobs J recognised this problem and said that "the manifest legislative purpose of fair dealing with minority interests would be defeated ... if the terms of their exit are to be dictated simply by the market place."[77] In addition, in their joint judgment, the majority of the High Court in *Gambotto*,[78] in considering whether the terms of the expropriation were fair, said that:

> The second element, that the terms of the expropriation itself must be fair, is largely concerned with the price offered for the shares. Thus, an expropriation at less than market value is prima facie unfair, and it would be unusual for a Court to be satisfied that a price substantially above market price was not a fair value. That said, it is important to emphasise that a shareholder's interest cannot be valued solely by the current market value of the shares. Whether the price offered is fair depends on a variety of factors, including assets, market value, dividends, and the nature of the corporation and its likely future.[79]

The fact that the offer price does not reflect the underlying value of the assets seems to have been given little weight in the exercise of judicial discretion.[80] Further, the courts have emphasised that the mere fact that the details of the scheme or offer are open to criticism or, that they may be improved, will be insufficient to justify a court order.[81] In contrast, a court may well intervene and make an order where false or misleading information has been provided to target company shareholders.[82] Failure to comply with the requirements of the relevant legislation may also be a valid ground of objection.[83]

76 (1990) 8 ACLC 138.

77 Ibid at 146. Also see the comments of Kirby ACJ in *Shell Australia CA (NSW)*, supra n 50 at 58.

78 HC, supra n 10, per Mason CJ, Brennan, Deane and Dawson JJ.

79 (1995) 182 CLR 432 at 447. Also see the comments of McHugh J at 457.

80 *Re Press Caps Ltd*, supra n 67; *Nidditch v Calico Printers Association*, supra n 50 at 288 per Lord Guthrie; *Re Shoppers City Ltd and M Loeb Ltd* (1969) 3 DLR (3d) 35 at 39 per Stark J.

81 *Re Sussex Brick Co Ltd*, supra n 50 at 291-293 per Vaisey J; *Re Grierson*, supra n 68 at 38 per Plowman J.

82 See the comments of Vaisey J in *Re Sussex Brick Co Ltd*, supra n 50 at 292-293. Further, in *Re Sheldon*, supra n 67, Holland J may have been prepared to intervene if it could have been established that the controlling shareholder acted with the purpose of reducing the value of minority held shares or its actions clearly achieved that result (at 100,059). It is doubtful whether a court will intervene where only insufficient information has been provided. Consider *Re Evertite Locknuts Ltd*, supra n 50 at 223-224 per Vaisey J and *Re Chez Nico (Restaurants) Ltd* [1992] BCLC 192 at 210 per Browne-Wilkinson V-C. An order for discovery was denied in *Re Press Caps* [1948] 2 All ER 638 but this has been described as a "very restricted view of the proper scope of discovery" by Hoffmann J in *Re Lifecare International Plc* [1990] BCLC 222 at 225.

83 *Re Western Manufacturing (Reading) Ltd* [1956] Ch 436 at 441 per Wynn-Parry J; *Australian Consolidated Press Limited v Australian Newsprint Holdings Ltd* (1960) 105 CLR 473 at 478 per Dixon CJ; *Re Deans*, supra n 52 at 99,627 per Hardie Boys J Rendard and Santamaria, supra n 16 at 12,027 and 12,050 suggest that an alternative is to issue an originating summons seeking a declaration that the power to compulsorily acquire shares cannot be enforced. See *Cockle v Carlingford Nominees Ltd & Anor*, supra n 50 at 65,124 per Barker J.

The difficulty in necessarily equating the fact that there has been approval by the holders of 90% of the relevant class of shares with "fairness", is that shareholders may have accepted for a variety of reasons, some of which may be unrelated to the fairness or otherwise of the offer. Shareholders may have been influenced by the acceptances of major shareholders, by written or oral representations made by officers of the company relating to its future prospects, by a desire to rationalise their investments without concern for the price offered, or simply by information (or the lack of it) contained in expert reports. For example, in *Gething v Kilner*[84] the board of a target company recommended that its shareholders accept the takeover offers made to them at £200 for every £100 of stock held. The board did this in circumstances where experts had advised that the offer price was inadequate. After stating that in a takeover situation the directors have a duty towards their shareholders, which includes a duty to be honest and not to mislead, Brightman J said that:

> I also accept that a shareholder in an offeree company may be prejudiced if his co-shareholders are misled into accepting the offer. I express this view because as soon as the appropriate percentage of shareholders have been misled and have assented, the minority become subject...to statutory powers of compulsory purchase. It therefore seems to me that a minority could complain if they were being wrongfully subjected to that power of compulsory purchase as a result of a breach of duty on the part of the board of the offeree company.[85]

Further, Browne-Wilkinson V-C in *Re Chez Nico*,[86] after affirming the view in *Re Hoare*[87] that a normal takeover bid by an outsider will usually be regarded as fair once acceptances have been received by a large majority of shareholders, said:

> In my judgement the approach in *Re Hoare* cannot apply to a case where the bidder is already a director and shareholder in the target company and it is shown that the information made available to the assenting shareholders falls far short of what should have been provided. The fact that 90% of the shareholders have accepted the bid cannot carry decisive weight if it is shown that their acceptance was obtained in ignorance of facts of which they should have been informed.[88]

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84 [1972] 1 WLR 337.

85 Ibid at 341-342. Rule 3.1 of the London City Code on Takeovers and Mergers now provides that "the board of the offeree company must obtain competent independent advice on any offer and the substance of such advice must be made known to its shareholders". In Australia, s 995 of the Corporations Law will be relevant. In *Re Lifecare International Plc*, supra n 82, Hoffmann J accepted that a recommendation of the board of directors must have a substantial effect on the reaction of shareholders and, if it can be shown that the "advice received by the board on the basis of which it made its recommendation was in some way flawed", the shareholder must " go some way towards discharging the burden on him" (at 224).

86 Supra n 82.

87 Supra n 50.

88 Supra n 82 at 207.

Of course, in many cases approval by a large majority *will* be a strong indication that an offer is fair. This, however, should not be assumed. It is important that the courts look closely at the particular circumstances of each case. If the Court does this, and concludes that the relevant acquisition should proceed, shareholders should still be able to expect an objectively fair price for their shares. The market will be "cogent (but not conclusive evidence)"[89] of this price. The ASC could provide assistance in this process by appointing one or more independent persons to investigate the terms of the offer and report to the Court. The remuneration could be fixed by the ASC and this, together with other proper expenses, could be shared between the offeror and the applicant in such proportions as the Court determines. Sometimes an offeror would have already obtained such a report as part of the takeover process. Unnecessary, improper or vexatious Court applications could be controlled by the Court having a power to award costs.[90] A sensitive policy issue which would need to be explored is whether any alteration to the underlying terms of acquisition should be made available to those holders who had previously accepted the offers.

4 Costs

If an applicant is successful it is reasonable to expect that the offeror will bear the costs of the application. However, in recognition of the special nature of compulsory acquisitions, some courts have ordered that the offeror even pay the costs of an unsuccessful applicant.[91] Usually, each party will bear its own costs.[92] Consideration should be given to whether there needs to be a specific provision dealing with the award of costs. Section 430C(4) of the UK Companies Act 1985 provides that no order for costs shall be made against a shareholder unless the court considers (i) that

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89 See Kirby ACJ in *Shell Australia*, supra n 50 at 587.

90 See n 93 below and accompanying text.

91 *Re Fraser Hinde & Sons Ltd*, supra n 50 and *Re Hoare*, supra n 50 where Lord Maugham at 376 described the granting of costs as a "small solatium".

92 *Re Evertite Locknuts Ltd*, supra n 50; *Re Trinidad Oil Co Ltd*, *The Times* April 13 1957; *Re Grierson*, supra n 68; *Re Deans*, supra n 52; *Re Sheldon*, supra n 67; *Shell Australia SC(NSW)*, supra n 50. The NSW Court of Appeal in *Shell Australia* held that an offeror's costs in defending an unsuccessful appeal by a dissenting shareholder were to be paid by the dissenting shareholder. Sheller JA (with whom Kirby ACJ and Meagher JA agreed) said at 594 that:

> It is not suggested and there is nothing to suggest that McLelland J did not appropriately exercise his discretion in regard to costs. However the costs of this appeal raise different considerations. The appellant had the opportunity to ventilate his objection to the compulsory acquisition of his shares in court. His application failed and he was not ordered to pay costs. He appealed and on the appeal has failed for the same reason he failed before McLelland J. He demonstrated no error in McLelland J's judgment. I see no reason why he should not like any other unsuccessful appellant pay the costs of the successful respondent which he has brought before the court.

the application was unnecessary, improper or vexatious; or (ii) that there has been unreasonable delay or unreasonable conduct in the proceedings.[93]

Registration

Provided the Court does not make an order to prevent compulsory acquisition, an offeror must proceed with the acquisition process within 14 days of (a) the expiration of one month after the day on which the s 701(2) notice was given; (b) the expiration of 14 days after the last s 701(9) statement was given, or (c) a s 701(6) Court application having been disposed of, whichever last happens.[94] The offeror should serve on the target company a copy of the s 701(2) notice and an executed share transfer form signed by the offeror and a person appointed by the offeror (on behalf of the holder of shares). The offeror should then pay, allot or transfer (whichever is relevant) the offer consideration to the target company. The target company will then register the offeror as the new holder of the relevant shares.[95]

A dissenting offeree may be undecided as to whether to challenge an acquisition by making the Court application. To have an opportunity to explore this possibility with other shareholders, perhaps with a view towards a combined action, is most worthwhile. From a policy viewpoint, it is not unfair or unreasonable for all shareholders to wait until the expiration of one month after the s 701(2) notice was given, *or* the expiration of 14 days after the last s 701(9) statement was distributed, before requiring the offeror to proceed with the acquisition. In contrast, it is submitted that it would be unreasonable for those shareholders who do not proceed with the Court application, to be denied the opportunity to receive the relevant offer consideration for their shares at the earliest possible moment. Considerable amounts of money could be involved and the offeror's obligation to acquire these shares is unaffected by the outcome of those Court applications which do in fact proceed.

On balance, although the operation of s 701(10) probably reflects the above policy

93 In *Shell Australia CA(NSW)*, supra n 50, the dissenting shareholder submitted that s 430C(4) restates the general policy developed by courts in England in relation to an award of costs in applications by dissenting shareholders. However, as the Court held that appeals from first instance decisions involved different considerations, this submission was not dealt with. In *Re Britoil* [1990] BCC 70 Nourse LJ recognised that the purpose of s 430C(4) is not to discourage minority shareholders from making a court application "except in cases which ought not properly to engage the attention of the court. If there is something which it is proper for the court to consider, the applicant, even though unsuccessful, ought not to have to pay the offeror's costs". (at 74). On the other hand, if it is thought desirable for shareholder applications to be actively discouraged, some modification to the wording of s 430C(4) will be required. An award of interest to compensate an applicant has been allowed in *Re Hoare*, supra n 50, *Re Grierson*, supra n 68 and *Re Carlton Holdings Ltd* [1971] 1 WLR 918. But, in *Re Deans*, supra n 52, an award of interest was denied. This denial of interest has been criticised by Beck, supra n 70 at 337. The notion of equality of treatment in Chapter 6 would surely demand the award of interest to an applicant. It is interesting to note that Lord Maugham in *Re Hoare* made no reference to the fact that the offer consideration there also consisted of shares in the offeror. In these cases it may be appropriate for the Court to award interest based on the fair money equivalent of the relevant shares.

94 Section 701(10).

95 Ibid.

considerations, the issue could be made explicit. A plain reading of s 701(10)(c) indicates that those shareholders who do not make the Court application may need to wait until all Court applications are disposed of before having their shares acquired. In other words, the 'disposal' of the last Court application will usually be the last event to happen. However, s 701(10)(c) should not be read in isolation. As any Court order made under s 702(6) will only affect the relevant applicant, s 701(10)(c) should be interpreted as only affecting those dissenting offerees who have actually made such application.

Once a s 701(2) notice is dispatched, the offeror is *entitled and bound* to acquire the shares to which the notice relates.[96] A failure to proceed with compulsory acquisition at the time required by s 701(10) may mean that the offeror will lose its entitlement to acquire the relevant shares. The obligation to acquire them, however, will remain. This obligation could be enforced by the relevant dissenting offeree(s) making application under s 743(1) and the Court, as a term of the order, awarding interest to recompense the dissenting offeree(s).[97]

Trusts and unclaimed consideration

The consideration received by the target company must be held on trust by the target company for the former holder of the shares.[98] In *Hespe and Ors v Surfers Paradise Forest Ltd and Ors*[99] Carter J said:

> The trust created by s 42(12) [Cf. s 701(11)] of the Code arises by reason of the power to compulsorily acquire the shares of the dissenting shareholders in a takeover. It is a specific case of a *statutory trust* created to protect a minority group of shareholders who have failed or refused to participate in the takeover.[100] (emphasis added)

Where the consideration held on trust consists of or includes money, that money must be paid into a bank account opened and maintained for that purpose only.[101] The money will then earn a commercial rate of interest before it is claimed by the former holder of the shares. The trustee should have access to this money at all times during the deposit period.

The target company must notify the former holder of the shares in writing as soon as practicable that the consideration has been received by it, and is being held by it pending instructions from the former holder as to how it is to be dealt with.[102] Where the offer consideration consists of shares in the offeror, the combined effect of ss 701(10)

96 Section 701(5).
97 Section 744(6).
98 Section 701(11).
99 (1985) 10 ACLR 182.
100 Ibid at 190.
101 Section 701(12).
102 Section 701(11).

and 701(11) requires the target company to become registered as the holder of the shares.[103]

The relationship between the target company as trustee, and the former shareholders as beneficiaries, was considered by Carter J in *Hespe*.[104] In that case, a series of forestry companies were the subject of a takeover offer by DEC Holdings Ltd ("DEC"). One of these forestry companies was Surfers Paradise Forestry Ltd ("SPFL"). The takeover was successful and DEC proceeded to compulsorily acquire the outstanding shares held by all dissenting offerees. DEC transferred the non-cash share consideration for the acquisition to SPFL. SPFL became registered as the holder of shares in DEC on trust for the former holders of shares in SPFL. Subsequently, DEC decided to develop a new tourist centre and resort complex. In order to raise the necessary capital, DEC proposed to increase its nominal share capital and to approve a rights issue to shareholders. This required the approval of a general meeting. Apart from an argument concerning a specific provision of the Queensland Trusts Act 1973, it was not disputed that SPFL could vote the shares which it held. The issue was whether SPFL (through its directors) should refrain from voting the shares unless and until the wishes of the beneficial owners were known. Carter J held that the trustee company should exercise the power to vote in what it bona fide believed was for the benefit of the company and its shareholders (the beneficiaries). There was no obligation on the trustee to ascertain the intentions of the beneficiaries before doing so. On the facts of *Hespe*,[105] Carter J decided that SPFL, by exercising the power to vote the shares, had discharged this duty. It will often be difficult to establish otherwise. The reference to "instructions" in s 701(11) is to the manner in which the trustee is to dispose of the consideration so that the beneficiary may obtain legal title. It does not "comprehend instructions from a beneficiary as to how he wishes the trustee to vote the shares held on his behalf at a general meeting of the company".[106] If the intentions of beneficiaries were known, it may be appropriate for the trustee to vote in accordance with those wishes. But, it is unclear whether the beneficiaries may "control" or "direct" the trustee.[107]

Section 702 deals with the treatment of unclaimed consideration. There is an initial obligation on the offeror to notify the former holder of shares. However, there is no ongoing obligation to endeavour to locate the former holder of the shares. Such an obligation should exist. Any reasonable expenses incurred could be defrayed out of the money or other property held on trust for the person or persons concerned[108]

103 Section 185(3) provides that any allotment or transfer of shares in a holding company to its subsidiary is void. But, there is an exemption in s 185(6) where the subsidiary is concerned as a trustee and neither the holding company nor any of its subsidiaries is a beneficiary.

104 Supra n 99.

105 Ibid.

106 Ibid at 191.

107 Consider *Re Brockbank* [1948] Ch 206; *Butt v Kelson* [1952] Ch 197, *Re Whichelow* [1954] 1 WLR 5; *Hayim v Citibank N.A.* [1987] 3 WLR 83

108 See sections 430(11), (13) and (15) of the 1985 UK Companies Act.

Section 414 of the Corporations Law

Section 414 effectively applies to all general takeover offers which are exempted from Chapter 6 of the Corporations Law. This includes for example, offers where the offeror is entitled to more than 90% of the relevant class of target company shares, and offers that are made for shares of a company with less than 15 members.[109] Although s 414 adopts similar concepts to s 701, the language that is used, and the commercial context in which it operates, is materially different from s 701. In addition, many of the provisions still closely resemble the original provisions included in the 1929 UK Companies Act. Section 414 is triggered if:

> A scheme or contract (not being a scheme or contract arising out of the making of takeover offers, or a takeover announcement, under Chapter 6) involving a transfer of shares in a class of shares in a company to a person, has been approved by the holders of at least nine- tenths in nominal value of the shares included in that class of shares (other than excluded shares).[110]

1 Scheme or contract

The word "contract" has a specific meaning. It is implicit from s 414 that a "contract" needs to be approved by relevant shareholders. However, in the context of a general takeover offer, contracts will only arise between an offeror and target company shareholders once those shareholders have accepted the terms of the relevant offer. In contrast, the word "scheme" is broad. As Dixon CJ said in *Australian Consolidated Press*,[111] it is a "vague and elastic"[112] word. It means a "plan or purpose which is coherent and has some unity of conception".[113] In *J F and H Roberts* Pennycuick CJ also adopted a broad interpretation and said "a scheme in this connection means, I think, no more than a set of provisions for the achievment of a given end".[114] On the facts of *Australian Consolidated Press*,[115] the High Court held that a direct offer to all shareholders in Australian Newsprint Mills Limited amounted to a "scheme involving the transfer of shares". It would also cover offers for shares of private companies.[116]

In those cases where a scheme is constituted by offers, offers will need to be made for *all* the shares, other than shares held by the offeror, in a class of shares. Such a

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109 Section 619(1).

110 Section 414(2).

111 Supra n 83.

112 Ibid at 479.

113 Ibid. Also, in Re *Gregory and Canadian Allied Property Investments Limited* [1979] 98 DLR (3d) 355 Carrothers JA, adopting a commercial interpretation of the corresponding provisions in the British Columbia Companies Act 1973, said that it is a "plan, design, formula or programme of action devised in order to attain some end, usually unilaterally described or stated as distinct from a contract which is made or entered into by and between two or more parties" (at 365).

114 Chancery Division, 8 March 1963 (unreported) but cited in Weinberg et al, *Weinberg and Blank on Takeovers and Mergers* (4th edn 1979) at 344 n 43.

115 Supra n 83.

116 For example, see *Re Bugle Press Ltd*, supra n 58 and *Re Dad's Cookie Co (B.C.) Ltd* (1969) 69 WWR 641.

"scheme" will *involve* a transfer of shares since its object is the transfer of shares.[117] The fact that an offeror holds shares in the target at the time offers are made does not prevent the offer forming part of a "scheme or contract".[118]

A scheme will also involve a transfer of shares where offers have been made for shares which may be issued as a result of the conversion of securities. In *Re Simo Securities Trust Ltd*[119] an offeror made an offer for all the issued shares in a class of shares of the target company, *and* all the shares in the target company which may be issued as a result of the exercise of convertible loan stock. This was acceptable. The loan stock was convertible at specific times and also once an offer was made for all or part of the shares in the target company. The offeror made provision in the offer for the holders of the loan stock to transfer their stock certificates to the offeror with an authority to enable the offeror to exercise the conversion rights and acquire the shares.

2 *Approval*

Section 414(2) requires "approval" by the *holders* of the relevant class of shares other than shares *held* by a nominee or, where the offeror is a body corporate, a subsidiary of that body ("excluded shares").[120] This may suggest that where a nominee or subsidiary of the offeror only has a right to be registered as the holder of shares (and so such shares were not *held*) those persons will be counted in calculating the nine-tenths approval. However, this may not be a problem as s 414(2) indicates that offers are to be sent to holders and only holders may approve. In any event, it may be appropriate to draft the section so that it relates to the acquisition of beneficial ownership.[121] Where a shareholder only accepts with respect to part of a holding, that shareholder will still be regarded as an approving shareholder (approved by the *holders* of...) for the purposes of s 414. It should refer to approval "in respect of not less than nine-tenths in value of the shares".[122]

"Approval" requires definite assent by each shareholder.[123] If any shareholder, for whatever reason, is an unwilling acceptor, that shareholder will still be regarded as having "approved" the "scheme".[124] This approval must be obtained within 4 months after the making of the offer and a s 414(2) notice is to be dispatched within 2 months

117 *Australian Consolidated Press*, supra n 83 at 479 per Dixon CJ.

118 *Lewis Emanuel & Son Limited*, supra n 38 at 39-40 per McLelland CJ.

119 [1971] 3 All ER 999.

120 Section 414(1). The definition of "excluded shares" also includes shares held by the offeror and, since offers will not be made for those shares, they also will not be counted in determining whether the requisite "approval" has been obtained.

121 See Weinberg et al, supra n 114 at 342.

122 Under earlier Australian legislation, the power of compulsory acquisition depended upon the offeror obtaining approval from the holders of at least nine-tenths in nominal value of all the shares on issue irrespective of the level of approval obtained within each class of such shares. See *Australian Consolidated Press*, supra n 83. This anomaly has now been removed.

123 *Australian Consolidated Press*, supra n 83 at 479-480 per Dixon CJ.

124 *Re Marston Valley Brick Co. Ltd*, English Court of Appeal, 11 November 1970 (unreported). Noted in (1971) *Sol Jo* 10.

after the offers have been *so approved*. The former period is not a fixed minimum during which the offer must remain open, but is rather a maximum period for gaining the approval of shareholders.[125] It is permissible for the offer period to be shorter than four months.

Offers are made under a scheme when the relevant documentation is dispatched. If a term of the original offer provides for extension of the time for acceptance, the 4 months continues to run from the date of the original offer and not from the date of extension.[126] Similarly, if the offeror reserves a right to increase the offer consideration, any revision of the terms will not affect the original offer.[127]

3 75% requirement

Section 414(5) introduces a 75% requirement. Acceptances from seventy-five per cent in number of the holders of shares will be required where the nominal value of the 'excluded shares' exceeds one-tenth of the aggregate nominal value of the 'excluded shares' and other shares to be transferred under the scheme or contract. Section 414(5)(a) suggests that, in the above circumstances, the offeror must offer the same terms to all holders of shares other than "excluded shares". It is implicit that where s 414(5) does not apply, the offeror may discriminate between shareholders by offering different terms. If there is to be a requirement to offer the same terms to all shareholders, it should be introduced in s 414(2) and not as part of s 414(5).

In addition to the general problems associated with the operation of the 75% requirement, there is a specific problem arising from the definition of 'excluded shares'. Since the definition does not include shares held by a holding company or an associate of the offeror, it may be possible to avoid compliance with s 414(5). In particular, if a subsidiary makes an offer for all the shares in the target company, the necessary approval level may result from the acceptance of the holding company. The NCSC criticised such transactions[128] and the Court, in such cases, may be prepared to prevent compulsory acquisition outright.

Minority Initiated Acquisition

Legislation following the recommendations of the UK Greene Committee[129] only provided an offeror with a right of compulsory acquisition. It did not provide a reciprocal

125 *Re Western Manufacturing (Reading) Ltd*, supra n 83 but contrast *Rathie v Montreal Trust Company* [1953] 4 DLR 289.

126 *Musson v Howard Glasgow Associates Limited* (1960) SC 371.

127 Weinberg et al, supra n 114 at 339. Section 428(7) of the 1985 UK Companies Act now specifically provides that where the offer makes provision for the revision of terms, a subsequent revision shall not be regarded as the making of a further offer. Any time limits imposed by the Act shall be referable to the date of the original offer. This provision was considered in *Re Chez Nico*, supra n 82.

128 See NCSC Media Release 89/8. In the Lavarch Committee Report, supra n 11 at 76 it was noted that the ASC had submitted that the definition of "excluded shares" be replaced with a reference to shares to which the offeree is entitled.

129 Supra n 2.

right for the benefit of the dissenting minority. It was not until 1945 that the Cohen Committee[130] recognised the asymmetry of treatment between majority and minority and recommended that a minority be given a right to require an offeror to purchase the shares held by them at a price to be agreed or, in default of agreement, to be settled by the Court.[131] In acknowledging that the position of a small minority in a subsidiary may be "anything but satisfactory",[132] the Cohen Committee[133] offered a way out, or 'second chance', for those persons who may otherwise be "locked in" following a successful takeover bid. Legislative provisions based on UK precedent now exist in ss 414 and 703 of the Corporations Law

Remaining shareholders

A holder of remaining shares can require an offeror to acquire its shares where the offeror has become entitled (pursuant to the takeover scheme, announcement or otherwise) to 90% of the relevant class of shares after the service of the Part A statement, or the making of the takeover announcement, and before the end of the takeover period.[134]

This power cannot be exercised until the offeror has dispatched a s 703(1) notice to the shareholder. There may be circumstances where a s 701(2) notice will *not* be served and yet a s 703(1) notice will be required. One situation is where an offeror has fulfilled the requirements for compulsory acquisition under s 701 but decides not to proceed. Another is where an offeror has become entitled to 90% of the relevant class of shares but has not satisfied an applicable 75% requirement. Less obvious (and probably rare as it may lead to an offeror breaching s 746) is the case where an offeror has obtained an entitlement to 90% of the relevant class of shares after service of the Part A statement[135] but decides not to dispatch offers. In all cases, a s 703 notice will still be required.

The term "remaining shares" is not defined. The context in which it is used indicates that it may mean the shares in respect of which offers were made and which are not registered in the name of the offeror at the end of the takeover period.[136] This will necessarily be wider than the definition of "outstanding shares". Renard and Santamaria[137] note that one consequence of this will be that accepting shareholders, who continue to

130 Supra n 36 at para 141.

131 Ibid.

132 Ibid.

133 Supra n 36.

134 Sections 703(1) and 703(2). In contrast, the operation of s 414(9) is contingent upon the transferee (offeror), or where the transferee (offeror) is a body corporate, any related body corporate, together having an accumulated beneficial entitlement to not less than 90% in nominal value of the relevant class of shares in the target company. Part of the accumulated beneficial entitlement must be obtained pursuant to a scheme or contract referred to in s 414(2).

135 This may be obtained by on-market share acquisitions in accordance with s 620(1).

136 Renard and Santamaria supra n 16 at 12,033. In contrast, R Levy in *The Laws of Australia* (The Law Book Company Limited, 1993), Title 4.6 at 141 says that it would be consistent with the approach under s 701 if the term "holders of the remaining shares" is construed to mean registered holders of shares to which the offeror is not entitled ".

137 Ibid.

be registered as holders of the relevant shares, will still be able to require acquisition. Further, although an offeror under s 701 will not be able to compulsorily acquire shares to which it was entitled at the time when the first of the offers was made holders of such shares may be able to their require acquisition under s 703.

The right to require an offeror to acquire remaining shares is not defeated if, after the 90% entitlement has been obtained during the takeover period, there is a share issue which causes the offeror's entitlement to shares in that class to fall below 90%.[138] However, if there is a share issue, it is unclear whether the holders of the newly issued shares can require the offeror to acquire them. On first appearance, this looks to be the reverse of what was considered in the context of s 701. However, the terminology of the legislation is materially different. A s 701(2) notice is dispatched to a "dissenting offeree" to acquire the "outstanding shares" held. Here, the s 703(1) notice is dispatched to the holders of "remaining shares" and those holders may require their acquisition. Provided offers have been made for these newly issued shares,[139] the holders of the shares should be able to dispatch the relevant notice.

A s 703(1) notice *must* be given to the holders of remaining shares before the end of one month *after* the end of the offer period.[140] Consistent with the position under s 701, this would prevent an offeror dispatching the notice before the end of the takeover period.[141] The period during which the s 703(1) notice can be given should commence once the 90% entitlement has been obtained. Where an offeror obtains the 90% entitlement by making on-market purchases after the Part A statement is served (and does not dispatch offers) the s 703(1) notice may presumably be given at any time after such entitlement has been obtained.[142]

Having fulfilled the s 703(1) requirements, an offeror must give the prescribed notice to those holders of remaining shares who are holders as at the date the notice is dispatched,[143] and who have not been given notice under s 701(2).[144] A s 703(1) notice cannot follow a s 701(2) notice. However, given the different time periods for the dispatch of notices,[145] it is quite possible for a s 701(2) notice to follow a s 703(1) notice. For example, an offeror may be undecided as to whether to proceed with

138 Section 703(1)(b).

139 The ASC's view of when offers can and should be made for newly issued shares is detailed at supra n 25.

140 Section 703(1)

141 See discussion on this issue at supra n 20

142 In these circumstances, there is no "offer period". The definition of "offer period" in s 603 contemplates that offers under a scheme or announcement have actually been made.

143 In *Kingston and Anor v Keprose Pty Ltd* (1988) 6 ACLC 226 at 234 Hope JA in commenting on equivalent wording in CASA said:

> ..there is nothing in the terms of the sub-section nor, so far as I can see, in its purpose, which would require the offeror to give the notice to a person registered at the time of the close of the takeover offer but not registered at the time of the giving of the notice.

144 Section 703(1).

145 Notices under ss 703(1) and 701(2) are to be given before the end of one and two month(s) respectively after the end of the offer period. This variation should be remedied.

compulsory acquisition at all or, as the decision in *Brierley*[146] shows, may be prevented from proceeding until some time after the end of the offer period. In these circumstances, the rights of remaining shareholders under s 703(1) may co-exist with the rights of an offeror under s 701(2). They are "simply alternative rights available to different parties".[147]

The recipient of a s 703(1) notice has three months in which to require the offeror to acquire the relevant shares.[148] Once a requisition has been made, the offeror is then entitled and bound to acquire those shares.[149] There is again a right and an obligation. In those cases where a Part A statement has been served, the acquisition will be on the terms applicable for the acquisition of shares as at the end of the offer period.[150] Where alternative terms are applicable, the acquisition will be on the terms the shareholder has elected under s 703(2) or, where no election has been made, on whichever of the terms the offeror determines.[151] In those cases where a 90% entitlement is obtained by an offeror, and no takeover offers are dispatched (although rare), it is unclear what will be the terms of acquisition. It may be appropriate for the terms to be the highest price paid or agreed to be paid by the offeror or a person associated with the offerer during the 28 days following service of the Part A statement. If a takeover announcement has been made, the acquisition will be on the terms applicable for the acquisition of shares as at the end of the offer period.[152]

As an alternative to the above, the offeror and shareholder may agree on the terms of acquisition or may apply to the Court to determine the terms of acquisition.[153] A sensitive policy issue will be whether any alteration to the underlying terms of acquisition should be made available to those holders who had previously required acquisition.

Non-voting securities

A holder of non-voting shares, renounceable options or convertible notes can require an offeror to acquire these securities where the offeror has become entitled to 90% of the *voting* shares in a company after the service of the Part A statement, or the making of the takeover announcement, and before the end of the takeover period.[154] The requirement is for a 90% entitlement to the total voting shares. There is no equivalent provision in s 414. 'Voting shares' are shares which confer a right to vote, not being a right to vote that is only exercisable in one of the limited circumstances detailed in the s 9 definition. It follows that non-voting shares either do not confer a right to vote or, if they do, such right is restricted to one or more of the circumstances detailed in the s 9 definition of 'voting shares'.

146 Supra n 29.
147 *Plaza Fabrics*, supra n 51 at 588 per Henry J.
148 Section 703(2).
149 Section 703(3).
150 Ibid.
151 Section 703(3)(a).
152 Section 703(3)(b).
153 Section 703(3).
154 Sections 703(4) and 703(8).

Where an offeror has become entitled to 90% of the voting shares of a company, the offeror has the potential to alter the rights and expectations upon which the holders of renounceable options and convertible notes invested in the company. Holders of these securities may be locked-in. Section 703 offers a way out. However, there is no way out for the holders of non-renounceable options. This is not surprising. Non-renounceable options are incapable of being assigned, whether to a successful offeror after a takeover bid or to anyone else.[155]

A s 703(4) notice *must* be given to the holders of non-voting shares, renounceable options or convertible notes before the end of one month *after* the end of the offer period.[156] The time during which this notice is required to be given should commence once the 90% entitlement has been obtained. Where the necessary entitlement to voting shares is obtained without dispatching offers, the s 703(4) notice may presumably be given at any time after the 90% entitlement has been obtained.[157]

There is a possibility of overlap between s 703(1) and s 703(4). Consider where a takeover scheme or announcement relates both to a class of voting and non-voting shares. If an offeror becomes entitled to 90% of each of these classes of shares during the takeover period, the offeror may be obliged to dispatch a s 703(1) notice to the remaining shareholders in the relevant class of voting shares *and* both a s 703(1) and s 703(4) notice to the remaining shareholders in the relevant class of non-voting shares. Further, the rights and obligations of offeror and shareholder under these subsections are not identical. In particular, although a s 703(1) notice cannot follow a s 701(2) notice (due to the wording of s 703(1)), it would seem that, with respect to the same shares, a s 703(4) notice may follow a s 701(2) notice. If this occurs, it will have important consequences. As in *Plaza Fabrics*,[158] the rights of an offeror under s 701 would co-exist with the holders of non-voting shares under s 703(8). It would then be open for the latter to insist upon Court determined terms of acquisition in accordance with s 703(8)(b).

A s 703(4) notice must be given to a holder of non-voting shares, renounceable options or convertible notes as at the date the notice is dispatched.[159] Within three months of such notice being given, the holder is able to require the offeror to acquire these securities.[160] Only those persons who are registered as holders at the time of service of the s 703(4) notice, and who are still registered as holders, may give the s 703(8) notice. In *Kingston*[161] the New South Wales Court of Appeal confirmed this interpretation pursuant to equivalent wording in CASA. From a policy viewpoint, it is difficult to justify a situation where persons who obtain a right to become registered as

155 This follows from the definition of "renounceable option" in s 603.

156 Section 703(4) and see discussion on this issue at supra n 20.

157 Supra n 142.

158 Supra n 51.

159 See the comments of Hope JA in *Kingston*, supra n 143 reproduced at n 143.

160 Section 703(8).

161 Supra n 143.

holders prior to the dispatch of a s 703(4) notice, *or* only obtain such a right after the dispatch of the s 703(4) notice, are precluded from requiring the offeror to proceed with the acquisition under s 703(8). Hope JA (with whom Priestley J agreed) did so by saying that the purpose of the CASA provisions was to prevent persons being involuntarily as distinct from voluntarily locked in a company. He said that:

> If a person buys options at a time when he knows he may be locked in if a current takeover bid is successful, there seems to be no reason why the legislation should protect him against a difficulty the risk of which he knowingly accepted and against which, as I will suggest, he could have protected himself by contract.[162]

These comments assume that a transferee will *always* be aware of the consequences of a successful takeover bid. This may not be the case. Further, as McHugh JA[163] points out, there are conflicting policy considerations and it is not clear that the making of contractual arrangements could work effectively in practice. Hope JA did countenance the possibility of an exception for "transmission on death or possibly other events".[164] In *Mercantile Mutual Life Insurance Co Ltd & Ors v Actraint No. 85 Pty Ltd (No.2)*[165] Jacobs J relied on the generality of the term "other events" to permit a company, which was only entitled to be registered as the holder of shares, to give the relevant notice. The circumstances were exceptional.[166] The legislation should, if necessary through amendment, offer protection to those persons who have a right to be registered as the holder of shares. Such persons should not be forced to remain in the company.

Once a s 703(8) notice is dispatched, the offeror is entitled and bound to acquire the relevant securities.[167] The terms of acquisition are as agreed, or as the Court determines on the application of either party.[168] If the terms of acquisition are proposed in the s 703(4) notice, the notice must be accompanied by an expert's report.[169] The expert must express an opinion about the fairness and reasonableness of the terms proposed in the notice and provide reasons for that opinion. A plain reading of s 703(5) indicates that these requirements can be avoided if the offeror proposes terms of acquisition otherwise than in the s 703(4) notice. This has been questioned by Jacobs J in *Mercantile Mutual*.[170] In that case the offeror was a wholly-owned subsidiary of Bond Corporation Holdings Ltd ("Bond"). Bond proposed terms of acquisition for the remaining preference shares in the target corporation some months after the offeror had dispatched a CASA s 43(4) [s 703(4)] notice to the holders of those shares. Jacobs J doubted that the Bond

162 Ibid at 235

163 Ibid at 242

164 Ibid at 235.

165 (1990) 1 ACSR 569.

166 See discussion of Jacobs J, ibid at 584-587

167 Section 703(8)(b).

168 Section 703(8)(b).

169 Section 703(5).

170 (1990) 1 ACSR 73 at 74-75 and supra n 165 at 576-577. The former is an application by non-voting preference shareholders to be paid an interim sum. The latter is the trial of the action.

proposal could have been made by the offeror unaccompanied by any expert's report and, as for the Bond offer itself, Jacobs J said:

> True it may be that it is made by a different legal entity from the offeror for JNT shares (Actraint), but the fact is that Bond is but the "alter ego" of Actraint, which indeed throughout described itself as "Bond", and in such circumstances, I would not hesitate to look behind the corporate veil in order to stifle an apparent attempt to avoid compliance with s 43(5) of the Code.[171]

Alternative Methods of Acquisition

Shares

Shareholders may place a very high value on their investment in a company.[172] Their expectation may be to remain as shareholders. However, it is clear that this expectation will be defeated where an offeror fulfils the requirements of s 414 or s 701 and proceeds to acquisition. Defeating the expectation of shareholders in this way is not unreasonable because the possibility of so acquiring minority held shares is well established. Problems arise where other methods, which usually do not operate to acquire minority held shares, are used for this purpose. Perhaps this was a concern of McLelland J in *Gambotto*[173] where he said that:

> It is to be observed that if a majority holding or controlling 75% or more of the issued capital of a company could validly expropriate the shares of a minority by an alteration to the articles for reasons of the kind advanced in this case, it would be unnecessary to have such provisions for compulsory acquisition of shares of dissenting minorities as are to be found in ss 414 and 701 of the Corporations Law.[174]

Further, in their joint judgment, the majority of the High Court in *Gambotto*,[175] said that:

> To allow expropriation where it would advance the interests of the company as a legal and commercial entity or those of the general body of corporators would, in our view, be tantamount to permitting expropriation by the majority for the purpose of some personal gain and thus be made for an improper purpose. It would open the way to circumventing the protection which the Corporations Law gives to minorities who resist compromises, amalgamations and reconstructions, schemes of arrangement and takeover offers.[176]

The real issue will be to determine what expectations the legal rules should generate.[177]

171 Supra n 165 at 577.
172 See R C Clark, *Corporate Law* (Little Brown 1986) at 505-507.
173 SC (NSW), supra n 10.
174 Ibid at 145.
175 (1995) 182 CLR 432.
176 Ibid at 446.
177 See Clark, supra n 172 at 507.

Recent decisions have suggested that the expectations of shareholders may be defeated by the use of alternative methods to acquire minority held shares.[178] In *Gambotto*,[179] Meagher JA said that:

> It can hardly be contended that all powers of expropriation are repugnant to the Corporations Law. The legislation in terms permits expropriations in ss 701-702 (takeover schemes), s 411 (compromises) and s 414 (schemes of arrangement.) Nor, in my opinion, could it reasonably be contended that these provisions constitute some sort of code governing the expropriation of shares.[180]

This recognition should mean that the emphasis will switch to ensuring that, when such methods are adopted, the nature and extent of the protection available to a minority is both adequate and consistent. At present, this protection varies. Court approval is required to sanction a compromise or arrangement and to approve a capital reduction, but is not required for alterations to the articles of association. Further, in those situations where Court approval is required, the focus of the Court, in dealing with such applications, will vary. For example, under s 411 the Court has the power to order meetings of creditors or members[181] and then, after the necessary meetings have taken place, to finally approve the relevant compromise or arrangement.[182] At both stages the Court is guided in the exercise of its discretion; first by s 411(2) and then by s 411(17). The latter is most important. It directs the Court to withhold approval unless it is satisfied that the compromise or arrangement has not been proposed for the purpose of enabling any person to avoid the operation of any provision of Chapter 6.[183] The Court's discretion to confirm a capital reduction under s 195 is not fettered in this way. Different considerations operate. It is clear from the structure of s 195 that the interests of creditors must be protected but, equally, the Court will ensure that the interests of the public and members are not ignored.[184]

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178 See, for example, *Nicron Resources*, supra n 10; *Re ACM Gold Ltd*, supra n 10; *Gambotto*, supra n 10. The range of alternative methods that may be used to acquire minority held shares is considered by Digby, supra, n 6.

179 CA (NSW), supra n 10.

180 Ibid at 471-472. Further, in *Nicron Resources*, supra n 10, Bryson J at 235 said:

> If a reduction of capital, selectively applied so as to expel a small minority, is an available machinery under the articles of association, the court should look on endeavours to use that machinery in a dispassionate way, without any predisposition for or against its use and without attempting to place itself in the position (which it cannot fully achieve) of controlling and regulating the choices made by shareholders among the available machinery.

Also see the comments of Hayne J in *Re Deniliquin Development Corporation Ltd*, (1994) 12 ACLC 261 at 262.

181 Sections 411(1), 411(1A) and 411(1B).

182 Section 411(6).

183 The operation of this provision has been considered in *Re ACM Gold Ltd*, supra n 10 and *Re Stockbridge Ltd* (1993) 9 ACSR 637. Also see ASC Policy Statement 60 "Schemes of Arrangement - section 411(17)."

184 In *Ex parte Westburn Sugar Refineries Ltd* [1951] AC 625, Lord Radcliffe at 635 said that:

> If the transaction is itself competent the court should only refuse its confirmation if what is proposed to be done is somehow unfair or inequitable; and the consideration of what is unfair or inequitable cannot well extend beyond consideration of the interests of creditors, shareholders and the general public, by which term is, I think, meant persons who may in the future have dealings with the company or may be minded to invest in its securities.

2 *Reduction of Capital*

Minority shareholders may be vulnerable to a selective or discriminatory reduction of capital; that is, one that affects some shareholders in a class of shares but not others. A majority may use its voting strength to pass a special resolution to authorise the return of capital to minority shareholders. The majority shareholder could be the sole survivor. This is to be contrasted with a return of capital to *all* shareholders in a class of shares in a company which consists of two or more classes of shares.[185]

It is clear that a selective capital reduction is permissible and not inherently objectionable.[186] In *Couper*,[187] for example, a company which originally carried on business both in England and America, terminated its American operations and sought to selectively return capital to its American shareholders. The House of Lords, in determining it to be fair and equitable, confirmed the reduction. However, there has been very little discussion of the factors which influence (or should influence) a court in exercising its discretion in these types of capital reduction. The recent decision of *Nicron Resources*[188] deals with the issue fully.

In *Nicron Resources*[189] Aztec Mining Company Ltd ("Aztec") and one of its controlled entities held 78.6% of the issued shares of Nicron Resources Ltd ("Nicron"). Of the remaining shares, 19.5% were held by one person and 1.9% dispersed widely. It was accepted in evidence by the Chairman of Nicron (who was also a director of Aztec) that the reason for proceeding by way of a capital reduction to remove minority shareholders was the perceived difficulty in fulfilling the requirements to proceed by way of compulsory acquisition.[190] The necessary special resolution of Nicron shareholders was obtained without Aztec, as majority shareholder, voting any of its shares. The holder of 19.5% of the shares voted in favour of the resolution. The fair money equivalent of the minority shares, as determined by independent expert valuation, was available. In these circumstances, Bryson J confirmed the reduction of capital and said:

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185 For examples of this see *Re Chatterley-Whitfield Collieries Ltd* (1948) 2 All ER 593 and *Catto v Ampol Ltd* (1989) 15 ACLR 307. Such reductions do not activate a variation of class rights procedure. See *Re Daniel Clifford Investments Ltd* (1948) SASR 278, *Re Saltdean Co Ltd* [1968] 1 WLR 1844; *House of Fraser PLC v ACGE Investments Ltd* [1987] 1 AC 387.

186 For example see *British and American Trustee and Finance Corporation Ltd v Couper* [1894] AC 399; *Re Bowman Thompson and Co* (1889), *Re Knowles Ltd* (1908), *Re Hamlyn Brothers Ltd* (1908), all cited by Dixon J in *Thornett v The Federal Commissioner of Taxation* (1938) 59 CLR 787 at 800-801; *Re Thomas De La Rue and Co Ltd* (1911) 2 Ch 361; *Re Rank Radio and Television Ltd The Times* November 19, 1963; *Re Robert Stephen Holdings Ltd* [1968] 1 All ER 195; *Ramsay Health Care Ltd v Elkington* (1992) 7 ACSR 73. *Nicron Resources*, supra n 10; *Re Shine Fisheries* (1994) 12 ACLC 223; *Re Deniliquin Development Corporation Ltd*, supra n 180; *Re Prime Group Holdings Ltd* (1994) 12 ACLC 308.

187 Ibid.

188 Supra n 10

189 Ibid.

190 Noted by Bryson J, ibid at 234.

> If the fair money equivalent of their shares or more is available to them, it is not in my judgment unfair or inequitable to minority shareholders that Aztec has not been required to go about a more elaborate and less certain procedural course before the objectors are required to part with their shares and accept that compensation.[191]

It could not be clearer. Compliance with s 195 and payment of the fair money equivalent for minority held shares is all that seems to be required.[192] Certainly, Bryson J appears to consider irrelevant the fact that, the only reason advanced for Nicron proceeding by way of capital reduction, was the problem Aztec would have in fulfilling all the necessary requirements to proceed by way of compulsory acquisition. The ASC has indicated that it may intervene to oppose court confirmation of a selective capital reduction if (i) shareholders have not received 'full and frank' disclosure of all material information to the reduction or, (ii) evidence exists to suggest that the proposal is unfair to expropriated or continuing shareholders.[193]

2 *Alteration to Articles of Association*

There are a number of ways in which an alteration to the articles of association can facilitate the removal of minority interests. An article may, for example, be adopted (a) which permits the board of directors or general meeting to compel any shareholder to sell or transfer shares to other members or, (b) which deems any member holding less than a certain number of shares in the company to have appointed the company as an agent to sell its shares to another at a price determined by independent valuation. The former is a discretionary article in that it requires a resolution of the board or general meeting to effect an acquisition. The latter is self executing. It is activated when a member holds less than the requisite number of shares. There are many possibilities.[194] It is open for any member of the relevant company to challenge the validity of an

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191 Ibid at 236.

192 Bryson J did acknowledge (at 231) that there could be some circumstances in which an "exclusively economic conspectus" was not appropriate "because of some personal dealings among those involved or for some other reason". He did not elaborate further. The fact that Aztec, as majority shareholder, did not vote any of its shares at the relevant meeting in which the resolution was passed, must also have been relevant.

193 See ASC Practice Note 29, "Selective Capital Reductions" at para 12. Details of what the ASC considers to be 'full and frank' disclosure are to be found in paras 18-33, 37 and 41-42. Further, in determining the fairness to minority shareholders, the ASC suggests that the interests of any instigator of the reduction (controlling shareholder or its associates) should be fully disclosed, and such persons should not vote on the relevant resolution. (at para. 34). In this context, also see the comments of the majority of the High Court in their joint judgment in *Gambotto,* supra n 10 at 446 and McHugh J at 459.

194 See the nature of the articles sought to be introduced in *Brown v British Abrasive Wheel Coy. Ltd* [1919] 1 Ch 290; *Sidebottom v Kershaw Leese and Coy Ltd* [1920] 1 Ch 154; *Dafen Tinplate Coy Ltd v Llanelly Steel Coy Ltd* [1920] 2 Ch 124; *Palazzo Corporation Pty Ltd v Hooper Bailie Industries Ltd and Ors* (1988) 14 ACLR 684; *Gambotto,* supra n 10.

alteration to expropriate a minority as being an abuse of majority power[195] or as contravening s 260 of the Corporations Law.[196]

In *Gambotto*,[197] the majority shareholders who controlled 99.7% of the issued share capital of WCP Ltd sought to adopt an article which empowered any shareholder entitled to 90% or more of the issued share capital of WCP Ltd to compulsorily acquire the remaining shares. The price at which the shares were to be acquired was determined by an independent expert's valuation. Although some minority shareholders commenced proceedings to challenge the validity of this alteration prior to the meeting at which the special resolution was to be considered, the meeting proceeded and the resolution was duly passed. The plaintiffs did not attend or otherwise exercise their voting rights. The majority shareholders were in attendance but abstained from exercising their voting rights at a poll. Those minority shareholders who were in attendance (representing about 16.4% of minority held shares) voted in favour.

The plaintiffs alleged that the purpose and effect of the amendment to the articles was to permit the shares of minority shareholders to be expropriated by majority shareholders. McLelland J, at first instance, agreed. He said that such amendment "amounts to unjust oppression of those minority shareholders who object"[198] and held the amendment to be invalid and ineffective. In so doing McLelland J described as "inadequate",[199] as a check on majority power, the criterion of "bona fide for the benefit of the company as a whole" in expropriation cases. Since the decisions in *Brown*,[200] *Sidebottom*[201] and *Dafen Tinplate*[202] all attempted to make some sense of this criterion, they were put to one side. McLelland J thereby rejected any notion of benefit to the company (as was clearly the case in *Sidebottom*[203] where the relevant article sanctioned

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195 See generally the cases cited above.

196 An argument raised in *Gambotto*, supra n 10 was the possibility that the adopted article contravened s 180(3)(c). This section provides that a member may not be bound by an alteration which increases or imposes restrictions on a member's right to transfer shares. Restrictions on transferability are to be assessed at the date of alteration. On the facts of the case, this argument was rejected. In fact, Meagher JA (CA (NSW) at 472) thought that the shares were transferable even after a notice of acquisition had been dispatched. In addition, in their joint judgment, the majority of High Court (at 448-449) said that:

> The respondents submit that Art 20A does not impose any restriction on the right of the appellants to transfer their shares in WCP because those shares would remain transferrable without restriction even after an expropriation notice had been issued. There is considerable force in this submission. To give section 180(3)(c) a wider interpretation could lead to the result that any amendment empowering the expropriation of shares would be invalid, notwithstanding that the amendment was made for a proper purpose and is fair in all the circumstances. Such a result would tilt the balance too far in favour of the minority. Accordingly, the appellants' argument on this point must fail.

197 Supra n 10.

198 Ibid at 144.

199 Ibid at 145.

200 Supra n 194.

201 Ibid.

202 Ibid.

203 Ibid.

the removal of any member who carried on a business in direct competition to the company) as being relevant in the exercise of judicial discretion.[204]

On appeal, the New South Wales Court Of Appeal reversed this decision. Meagher JA agreed that the 'bona fide benefit' test was difficult to apply and said that "it is scarcely an apt test to apply to shareholders, who are not fiduciaries, who can legitimately look after themselves, and who do not have to concern themselves with the company's benefit."[205] Nevertheless, Meagher JA relied on comments made by Latham CJ and Dixon J in *Peters American Delicacy Co Ltd v Heath*,[206] and recognised that any benefit to the company from adoption of the proposed article will be an important consideration in the exercise of judicial discretion. Since, on the facts, there was clear evidence of company benefit flowing directly from the acquisition of minority held shares, and the proposed acquisition price was adequate, the article was held to be valid.

An appeal to the High Court of Australia was allowed with the relevant article being held to be invalid and ineffective.[207] In the circumstances of the case, where what was contemplated was an alteration of the articles to allow an expropriation of the shares of the minority, the High Court rejected as inappropriate the criterion of bona fide for the benefit of the company as a whole. In their joint judgment, the majority of the High Court said that:

> ... in a case such as the present where what is involved is an alteration of the articles to allow an expropriation by the majority of the shares, or of valuable proprietary rights attaching to the shares, of a minority...the immediate purpose of the resolution is to confer upon the majority shareholder or shareholders power to acquire compulsorily the property of the minority shareholder or shareholders. Of itself, the conferral of such a power does not lie within the "contemplated objects of the power" to amend the articles.
>
> ...The inclusion of such a power in a company's constitution at its incorporation is one thing. But it is another thing when a company's constitution is sought to be amended by an alteration of articles of association so as to confer upon the majority power to expropriate the shares of a minority. Such a power could not be taken or exercised simply for the purpose of aggrandising the majority. In our view, such a power can be taken only if (i) it is exercisable for a proper purpose and (ii) its exercise will not operate oppressively in relation to minority shareholders. In other words, an expropriation may be justified where it is reasonably apprehended that the continued shareholding of the minority is detrimental to the company, its undertaking or the conduct of its affairs - resulting in detriment to the interests of the existing shareholders generally - and expropriation is a reasonable means of eliminating or mitigating that detriment.[208]

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204 The ASC, supra n 10 at 121 recommended that alterations to articles of association to permit compulsory acquisition should be "abolished or made subject to disallowance by the ASC".

205 Supra n 10 at 471.

206 (1938) 61 CLR 457.

207 (1995) 182 CLR 432.

208 Ibid at 444-445 per Mason CJ, Brennan, Deane and Dawson JJ.

In applying this test to the facts of the case, the majority said that:

> The immediate purpose of the amendment was to allow the expropriation by the majority shareholder of the shares held by the minority, including the shares held by the appellants. There is no suggestion that the appellants' continued presence as members puts WCP's business activities at risk or that the appellants have in some way acted to WCP's detriment. Nor is there any suggestion that WCP sought 100% ownership in order to comply with a regulatory regime. All that is suggested is that taxation advantages and administrative benefits would flow to WCP if minority shareholdings were expropriated and WCP were to become a wholly-owned subsidiary of IEL. *In our view, however, that cannot by itself constitute a proper purpose for a resolution altering the articles to allow for the expropriation of a minority shareholder's shares.* In that regard, it is not irrelevant to note that it is difficult to conceive of circumstances in which financial and administrative benefits would not be a consequence of the expropriation of minority shareholdings by a majority shareholder.[209] (emphasis added)

3 *Reform*

Given these developments, it must be accepted that the compulsory acquisition provisions will coexist with other methods to acquire minority held shares. This, in itself, is not objectionable provided there is both adequate and consistent protection available to minority shareholders. In reviewing this protection, it may be helpful to consider the following questions. Should there be a requirement of Court confirmation in all cases where an alternative method is used to acquire minority held shares? Should there be rules or guidelines (including any guidelines issued by the ASC) to assist the Court in exercising its discretion in particular circumstances? For example, provided there has been compliance with s 195, should the payment of a fair money equivalent for minority held shares be sufficient to obtain Court confirmation for a selective capital reduction? Is it appropriate to also consider whether a "benefit" (perhaps material), will accrue to the company following confirmation of the reduction? Or, is the appropriate way forward, to leave it to the Court to assess the fairness or otherwise of the proposal on the evidence that is presented?

In the United States, and simply by way of contrast, many of the underlying issues

209 Ibid at 448. McHugh J delivered a separate judgment and concluded that the resolution adopting the relevant article was invalid. However, in his view, a company may only alter its articles for the purpose of enabling a shareholder to acquire the shares of existing shareholders when the acquisition is necessary to protect or promote the interest of the company and when the alteration will not be oppressive to those shareholders (at 453). "Independently of any question of oppression, the alteration of articles for the purpose of expropriating a member's shares will be valid only if it will enable the company to pursue some significant goal, or to protect itself from some action, that is external to the company. Administrative convenience or cost, for example, could never by itself justify an alteration for the purpose of expropriation" (at 455). McHugh J also said that to prevent an alteration for the purpose of an expropriation from being oppressive, the expropriators will need to act fairly (at 456-457) and he accepted that the concept of fairness had two aspects: fair dealing and fair price. On the facts, he concluded that the principal goal to be achieved by the alteration was a legitimate business objective and, therefore, would justify the expropriation. However, the company failed to prove that the expropriation was not oppressive.

raised by the above questions are tackled under the framework of statutory 'merger' provisions (short form, long form, compulsory share exchanges and other variations) and 'appraisal' rights.[210] For example, section 11.02(a) of the 1984 Revised Model Business Corporation Act provides that a corporation may acquire all of the outstanding shares of one or more classes of shares of another corporation if the board of directors of each corporation adopt, and a majority of shareholders approve, the exchange.[211] A shareholder who dissents from a share exchange is entitled to payment of the fair value of the relevant shares.[212] It is said that:

> Chapter 13 deals with the tension between the desire of the corporate leadership to be able to enter new fields, acquire new enterprises, and rearrange investor rights, and the desire of investors to adhere to the rights and the risks on the basis of which they invested. Most contemporary corporation codes in the United States attempt to resolve this tension through a combination of two devices. On the one hand, the majority is given an almost unlimited power to change the nature of the enterprise and the rights of its members. On the other hand, the members who dissent from these changes are given a right to withdraw their investment at a fair value.[213]

Convertible securities

It will be apparent that the existing legislative provisions do not allow an offeror to compulsorily acquire options or convertible notes. Sections 414 and 701 only confer acquisition rights with respect to shares.[214] However, an offeror may be able to acquire those securities directly after having negotiated the terms of acquisition. The acquisition of securities which confer rights over unissued shares are not prohibited by s 615. However, subject to a limited exception in s 627, any voting shares acquired as a result of the exercise of such securities may be regulated, and reference will need to be made to the provisions of Chapter 6. Of course, where an offeror is initially entitled to 90% or more of the relevant class of voting shares, any further acquisitions will not be prohibited.

As an alternative, it may be possible to amend the provisions of the Convertible Note Trust Deed (for those convertible note issues that have one) to allow early redemption of convertible notes or, instead, to proceed with a creditors scheme of

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210 Digby, supra n 6 at 119-122 provides an overview of these provisions, with specific reference to Delaware and California.

211 Section 11.03(e) provides that, unless the Act, the articles of incorporation, or the board of directors require a greater vote or a vote by voting groups, the plan of merger or share exchange must be approved by a majority of all the votes entitled to be cast on the plan by that voting group. Section 11.03(f) details the situations where seperate voting by voting groups is required.

212 Section 13.02.

213 See W Hamilton, *Corporation Finance, Cases and Materials* (West Publishing Co., 2nd edn, 1989) at 800.

214 According to Brooking J in *PS (Enterprises) Nominees Pty Ltd v Humes Ltd & Anor* (1989) 7 ACLC 944 at 953, the power of modification in CASA s 58 [CL s 730] could not be used to authorise the compulsory acquisition of convertible securities. Even if it could, Brooking J would have considered it a "highly questionable exercise of discretion" (at 953) if it had been used to do so.

arrangement in accordance with s 411. A convertible noteholder is clearly a "creditor" for the purposes of s 411. And, there is now considerable authority that an option holder, who is entitled to an award of damages if shares are not issued following the exercise of the option, falls within the ambit of the section as a "contingent creditor".[215]

In the UK an offeror may compulsorily acquire convertible securities. Section 430F of the UK Companies Act treats such securities as a separate class of shares in the company if they are convertible into or entitle the holder to subscribe for shares. Consideration should be given to including a similar provision in Australian law.[216]

Conclusion

The Australian compulsory share acquisition provisions are in need of reform. Discussion on this issue, until now, has focussed almost exclusively on the nature of compulsory acquisition itself and the acquisition thresholds. Any future review will, firstly, need to deal with the former issue and reach a conclusion on whether there should continue to be a power of compulsory acquisition. If it is agreed that there should, it will be important for there to be a comprehensive analysis of existing provisions. The s 701 acquisition thresholds and calculations are only one aspect of this problem. There will also need to be a review of all aspects of s 701 and a co-ordinated analysis involving s 414, ss 701-703 and the alternative methods of acquisition. On the assumption that the existing legislative structure remains in place, some of the problems which will be faced in this process have been identified, and possible areas for reform have been suggested. There will be others. One problem that has not been specifically addressed, but will have become clear from the discussion, is the difficulty presented by the use of the technical and, sometimes, impenetrable language in the legislation. This is not a new theme. It is hoped that, as part of any reform, any opportunity to reduce unnecessary complexity will be not be missed.

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215 See *Re Austamax Resources Ltd* (1986) 10 ACLR 194; *Re Asia Oil and Minerals Ltd* (1986) 5 NSWLR 42; *Re BDC Investments Ltd* (1988) 6 ACLC 85; *Re US Masters Ltd* (1991) 4 ACSR 462.

216 This accords with evidence to the Edwards Committee, supra n 32 at para 13.48.

Chapter 3

Disclosure Obligations in Corporate Squeezeouts

Paul Redmond[1]

The decision of the High Court of Australia in *Gambotto v WCP Ltd* is primarily concerned with questions going to proper purpose limitations upon the exercise of the power of alteration of the corporate constitution. A secondary, but not insignificant, aspect of the decision relates, however, to the disclosure obligations of those who initiate proposals for constitutional amendment to create or invoke machinery for the elimination of minority interests. These disclosure obligations arise principally under the general law and create a distinct standard by reference to which validity of the resolutions is tested. Those obligations are the subject of this chapter.

Modern corporate law confides decisional authority to the general meeting in relation not only to fundamental questions of corporate structure and but also in relation to transactions where the board's independence of judgment is compromised by personal interests of individual directors. On the other hand, in most publicly held companies the number of shareholders is such as to preclude physical attendance by only a small minority of members. Shareholder decisions are necessarily taken by proxy votes solicited and exercised on the basis of information circulated in advance of the meeting. The fairness and accuracy of this information underpins the integrity of the shareholder voting and consent mechanism. Its assurance is most sorely needed in resolutions to eliminate minorities.

This chapter explores the disclosure obligations imposed at general law upon those bringing forward motions for the expropriation of minority interests by constitutional amendment or other collective shareholder action, such as occurred in *Gambotto*. However, to frame these questions in a wider but related context, the chapter commences with a survey of disclosure obligations applicable to the principal statutory modes of compulsory acquisition.

Specify Statutory Disclosure Obligations Applying to Compulsory Acquisitions

The *Gambotto* mode of effecting an expropriation (or "squeezeout") of minority

1 Dean and Professor of Law, Faculty of Law, The University of New South Wales

interests is but one of several routes to that end. Several modes of compulsory acquisition are created by statute, including

- acquisitions under s 701 following a Chapter 6 bid;
- acquisitions pursuant to a scheme or contract under s 414;
- acquisitions pursuant to a scheme of arrangement under s 411; and
- selective reductions of capital under s 195.

Before examining the disclosure obligations applicable to each mode, three preliminary observations are made. First, the disclosure requirements imposed with respect to each of these modes follow a variegated pattern. Second, the variegations do not always reflect transparent functional differences in information needs or in policy objective. Third, no clear principle is evident which determines the shape and content of particular disclosure requirements.

Acquisition under section 701 following a Chapter 6 bid

No further specific disclosure obligation is imposed by s 701, the provision enabling compulsory acquisition pursuant to a formal bid, beyond those applying to the bid itself. Where, however, an offeror has become entitled to not less than 90% of the voting shares, and is obliged to give notice under s 703(4) to the holders of non-bid securities if it proposes terms for the acquisition of those securities by the offeror, the notice must be accompanied by a copy of an independent expert's report stating whether in the expert's opinion the terms proposed in the notice are fair and reasonable and giving the reasons for stating that opinion: s 703(5). The report must set out particulars of any relationship which the expert has with the offeror and its associates, particulars of any pecuniary or other interest the expert has which may reasonably be regarded as affecting the report's independence, and particulars of the expert's fee or benefit: s 703(7). This requirement for an independent expert's report only arises if the offeror proposes terms for the acquisition of non-bid securities. Compulsory acquisitions under s 701 are, of course, made only in consequence of a formal takeover scheme or takeover announcement which attracts the detailed disclosure obligations imposed upon a bidder through the Part A or Part C statements and upon the board of the target company through the Part B or Part D statements. Relevantly, the Part A statement requires disclosure, inter alia, of

- changes in the target's financial position since its last balance sheet in so far as they are known to the offeror (cl 14);
- the offeror's intentions regarding continuation of the business of the target company;
- any major changes to be made to that business;
- future employment of present employees of the target (cl 20);
- benefits proposed to be given to officers of the target company (cl 12); and

- any other information material to the making of a decision by an offeree whether or not to accept an offer (cl 17).

Further, where the offeror is entitled to not less than 30% of the voting shares in the target or the other affinity relationships of s 648 are engaged, the target's Part B statement must be accompanied by a report stating whether in the expert's opinion the takeover offers are fair and reasonable and setting out the reasons for forming that opinion.

Acquisitions pursuant to a scheme or contract under s 414

A compulsory acquisition effected under s 414 arises only on the margins of a Chapter 6 bid - specifically, where a Chapter 6 bid is not required; the acquisition is still, however, subject to s 615 and to s 195 where they are applicable to the acquisition. Court approval is not otherwise required nor, indeed, is approval by a meeting of shareholders. The power of compulsory acquisition under s 414 is not made subject to any specific disclosure obligations and courts have been unwilling to infer any such disclosure obligations into the terms of the statutory power.[2]

Compulsory acquisition pursuant to a scheme of arrangement under s 411

Schemes of arrangement may provide for the compulsory acquisition or extinguishment of corporate securities, usually in exchange for a cash consideration or for securities in another corporation. Compulsory acquisition under a scheme of arrangement is subject to a specific mandatory disclosure regime very broadly parallelling, but less extensive than, that applying to formal bids under Chapter 6. Thus, the court must approve the explanatory statement required by s 412(1)(a) to accompany notices of meeting for the scheme meetings: s 411(1). The Australian Securities Commission (the Commission) must be given 14 days notice of the application to convene the scheme meetings and the court must be satisfied that the Commission has had a reasonable opportunity to examine the terms of the proposed arrangement and the draft explanatory statement relating to it, and to make submissions to the court in relation to both: s 411(2).

Where a meeting is convened by the court, the company is required to send with every notice convening the meeting that is sent to a creditor or member a statement (the explanatory statement) which

- explains the effect of the compromise and arrangement and, in particular, sets out any material interests of the directors, whether as directors, members or creditors of the company or otherwise, and the effect on those interests of the compromise or arrangement in so far as that effect is different from the effect of the like interests of other persons; and

- sets out such information as is prescribed and any other information that is material to the making of a decision by a creditor or member whether or not to

2 *Re Western Manufacturing (Reading) Ltd* [1956] 1 Ch 436 at 446, cited in Q Digby, "Eliminating Minority Shareholders" (1992) 10 C&SLJ 105 at 126n.

agree to the compromise or arrangement, being information that is within the knowledge of the directors and has not previously been disclosed to the creditors or members: s 412(1).

The prescribed information is specified in Part 3 of Schedule 8 to the Corporations Regulations (reg 5.1.01) and is considerably less extensive than that required under formal bids. Thus, the explanatory statement must state

* in relation to each director, whether the director recommends acceptance of the scheme and his or her reasons for doing so;
* the number of securities the subject of the scheme which are held by each director and the director's voting intention with respect to those securities;
* particulars of benefits proposed to be given to directors and executive officers of the company the subject of the scheme, or of any related company, as compensation for loss of office; and
* particulars of the intentions of directors with respect to the continuation of the business, major changes to the business and future employment of present employees.

An independent expert's report is required where parties to the scheme have a common director or where one of them is entitled to more than 30% of the voting shares in another scheme company. There are no clauses in Part 3 corresponding to the provisions of s 750 with respect to the disclosure of material changes to the financial and other circumstances of the target company.

The Corporations Law requires the Commission, and ultimately the court, to scrutinise any scheme carefully before approval. The scheme proposal must be outlined candidly: "the factual cards must not be played close to the chest but laid face up on the table in good lighting conditions."[3] Where the scheme proposal involves difficult questions of commercial judgment and matters of degree and conjecture as to future prospects, it is said that there is room for a range of opinion and perfection is not expected; the statement is challengeable if its presentation is in such a form as to distort fair consideration of the proposal, whether by unbalanced presentation, intentional obfuscation or other unfair sales technique.[4]

A court may not approve a compromise of arrangement under s 411 unless it is satisfied that has not been proposed for the purpose of enabling any person to avoid the operation of Chapter 6 or unless the Commission states in writing that it has no objection to the compromise or arrangement: s 411(17). (The prohibition of s 615 does not apply in relation to an acquisition of shares under a compromise or arrangement approved by the court under s 411: s 625.) The Commission has indicated that it will look to the

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3 *Re Pheon Pty Ltd* (1986) 11 ACLR 142 at 156.

4 *Re Crusader Ltd* (1995) 17 ACSR 336 at 343-344.

disclosure requirements contained in Part A and the Eggleston principles expressed in ss 731 and 732 when considering whether an acquisition under a scheme of arrangement is capable of being effected under a takeover scheme under Chapter 6. In particular, the Commission considers that shareholders affected by a scheme acquisition should have access to

- the type and standard of information that would be provided to them under a Part A statement if the provisions of Chapter 6 had applied to the transaction; and
- adequate disclosure as to the voting power and intentions of the acquirer of shares and its associates with respect to voting to approve the proposed scheme of arrangement: *ASC Policy Statement 60*, para 12(e), (f).

Selective reductions of capital under s 195

Where compulsory acquisition is effected through a selective reduction of capital under s 195, no specific statutory disclosure requirement applies to the special resolution or judicial confirmation procedure. However, where directors have not made sufficient disclosure of the benefits that would flow to them as a result of the proposed reduction or of their interest in the proposal, judicial approval may be withheld on the grounds of fairness.[5] Further, in relation to squeezeouts effected through selective capital reductions, the Commission's *Practice Note 29* outlines a disclosure regime, albeit of uncertain status and force, founded as it is solely upon an interpretation of general law disclosure requirements and a rather exiguous body of case law on the application of the fairness standard for judicial confirmation where disclosure is inadequate.

The Corporations Law does not require the Commission to be notified by a company proposing a selective capital reduction. The Commission's policy is that, if a copy of the notice of meeting is given to it at the same time as it is given to shareholders, "it will increase the probability that the Commission will decide whether the proposal (and the procedure) is fair by the time the company makes the application for confirmation": *ASC Practice Note 29*, para 43. In this Practice Note the Commission also sets out its views on the disclosure requirements for capital reductions under s 195. These requirements draw upon the general law duties of directors preparing notices of meetings to fully inform shareholders of the proper business of the meeting and to avoid misleading material. (These disclosure obligations are considered in the following section.) Specifically, the material which the Commission considers should be disclosed falls within three classes. First, expressed in general terms (at para 20), companies must disclose:

- all facts and information reasonably necessary to enable the shareholders to make an informed decision as to how to vote;
- a reasonable description of what is actually proposed to be done; and

5 See, eg, *Re Campaign Holdings Ltd* (1989) 15 ACLR 762.

- all (not just some) of the material reasons for that proposal.

Second, the Commission considers that the notice of meeting to consider a resolution for a selective capital reduction should be accompanied by an explanatory memorandum containing all information known to the company and its directors material to the making of the decision by shareholders. The explanatory memorandum should disclose all interests of directors in the securities affected by the capital reduction and in securities of the company generally, and any general interest in the broad proposal to be effected: paras 23, 24. Individual directors should also indicate their voting intentions, what he or she recommends and why, and should disclose any interest of the director or an associate that may reasonably be expected to be capable of influencing the director in making the recommendation: para 26.

The Commission also considers that an independent expert's report should usually accompany the explanatory memorandum to satisfy the information requirements of fairness "because the directors of the company will frequently be interested persons"; the report should state whether the proposal was fair and reasonable to the expropriated and to the continuing shareholders in that it strikes a fair balance between the interests of the persons whose shares are to be cancelled and those who will remain in the company: para 27.

The Commission considers that the preparation, underlying principles and content of an expert's report should follow the requirements applicable to an expert's report under the Corporations Law, particularly under Chapter 6; in particular:

- the independent expert should prepare the report as if it were a report for shareholders voting on a resolution under s 623 (paras 28-29);
- the explanatory memorandum should also disclose any benefits in relation to the capital reduction offered to any person which are not being offered to all shareholders, whatever their source (para 31);
- the expert is also required to consider whether any interested person will receive a benefit not offered to the expropriated shareholders (para 32);
- the Commission also requires the explanatory memorandum to include a statement that case law "strongly indicates that the court ... will look to the views and votes of the persons whose shares are to be cancelled ahead of the views and votes of the persons who will remain as the major shareholders or controllers of the company" (para 37);
- the explanatory memorandum should also disclose voting intentions on the special resolution, including whether any affected shareholders are not voting on that resolution and whether any shareholder is voting as a separate class (para 41); and
- the company should ask whether the instigator of the resolution or its associates

intend to vote on the resolution and disclose the result of these enquiries: para 42.

The elaborate disclosure regime constructed by the Commission poses fundamental questions with respect to the scope of disclosure obligations at general law upon those proposing resolutions before shareholder meetings. They also underscore the role performed in disclosure policy by the general law and its complements in Trade Practices Act 1974 s 52 and Corporations Law s 995. These doctrines underpin minority protection against squeezeouts effected by constitutional alteration.

Compulsory Acquisition Effected Through the Exercise of Constitutional Powers

Compulsory acquisition may also be effected through the exercise of powers of expropriation contained in the memorandum or articles of association, including those newly introduced into the articles for the purpose by an alteration pursuant to ss 173 or 176[6] This was, of course, the mode of expropriation challenged in *Gambotto*. No particular disclosure requirements are stipulated by statute for the exercise of powers of expropriation under the constitution, or for a constitutional amendment to introduce such powers, save only for those applying to shareholder resolutions at general law.[7] As the *Gambotto* decision makes clear, however, these obligations are both substantial and highly nuanced to the elements of the specific alteration. The balance of this chapter explores the scope and content of these obligations, initially as explicated in the *Gambotto* decision itself, and then by reference to the general body of decision applicable to such transactions.

The place of disclosure obligations in the Gambotto decision

1 The joint judgment

Certainly, the joint judgment of Mason CJ, Brennan, Deane and Dawson JJ (here referred to as the joint judgment) emphasised that a constitutional alteration introducing an expropriation power must be fair in the circumstances, both in substance and procedure, and that procedural fairness obliges the majority shareholder to disclose "*all relevant information leading up to the alteration*"[8] (emphasis added). The

6 Depending upon the capital structure of the company and the provisions of its articles, the class rights procedures may be engaged in particular cases.

7 In its submission to the Lavarch Committee, the Commission argued that it should be given prior notification of any proposal to introduce an expropriation power into a company's constitution and that it should have power to require that shareholders be provided with a report of an independent expert before voting on the proposal: Companies and Securities Advisory Committee, *Compulsory Acquisitions, Issues Paper*, March 1994, at 28. The proposal was not referred to in the Committee's report, much less adopted.

8 (1995) 182 CLR 432 at 446, citing only *Re John Labatt Ltd* (1959) 20 DLR (2d) 159. The joint judgment indicated that procedural fairness also "presumably" requires the shares be valued by an independent expert although whether procedural fairness precludes majority shareholders from voting "is a question that is best left open at this stage" (at 446).

procedural fairness requirement, together with its substantive fairness complement,[9] together express the limitation that the exercise of the alteration power to introduce expropriation machinery must not oppress shareholders against whom it is exercisable. In addition, of course, the power of alteration must be exercised for a proper purpose. The purpose aspect is canvassed elsewhere in this book;[10] this chapter is concerned solely with disclosure obligations under the oppression aspect.

In *Gambotto*, Mason CJ, Brennan, Deane and Dawson JJ interpreted the challenge to the constitutional alteration as being made exclusively on the grounds that its purpose was improper, and that there was no objection to the resolution on the grounds of fairness.[11] Accordingly, for the joint judges, the precise content and contours of the disclosure obligation of those propounding the resolution did not arise for decision. It is clear, however, that the joint judges accepted that the onus is upon those supporting expropriation to establish its validity under both elements of purpose and fairness.[12] This approach, it is said, largely alleviates the sting of practical difficulties, such as poor access to information, that would otherwise confront minority shareholders.[13]

Only one case is cited in the joint judgment with respect to the scope of disclosure obligations. In *Re John Labatt Ltd* the Supreme Court of British Columbia declared that a purported exercise of a statutory power of compulsory acquisition was a nullity on several grounds including failure to make full disclosure to the shareholders "of all the essential facts at the outset."[14] The court did not particularise the information deficits nor canvass the principles determining the scope of disclosure obligations generally.

2 *The judgment of McHugh J*

The position was otherwise for the remaining judge. McHugh J held that the expropriation power was validly inserted into the articles provided that it was necessary to protect or promote the interests of the company *and* the alteration was not oppressive to the shareholders against whom it was exercisable. He differed from the joint judges both with respect to the content of the purpose constraint to which the alteration power is subject and in the application and, perhaps, interpretation, of the oppression element. Present concern is with the latter element only.

It is common ground between all the judges in *Gambotto* that, to prevent an expropriatory alteration being oppressive, the majority must act fairly. McHugh J was more explicit in asserting that the concept of fairness has two basic aspects: fair dealing

9 The substantive fairness requirement is largely concerned with market price but not exclusively; whether the price is fair "depends on a variety of factors, including assets, market value, dividends, and the nature of the corporation and its likely future" (at 447).

10 See chapters 1, 6 and 9.

11 At 448.

12 At 447.

13 At 447.

14 (1959) 20 DLR (2d) 159 at 162.

and fair price.[15] In distinguishing between these two aspects, and formulating their content, McHugh J drew upon the decision of the Supreme Court of Delaware in *Weinberger v UOP Inc*.[16] While the joint judges did not refer to *Weinberger*, its influence upon their conception of the fairness requirement is perhaps evident in the distinction which they draw between its substantial and procedural elements. The decision in *Weinberger* is noted later in this chapter.

For McHugh J, as for the joint judges, prima facie the fair price requirement is satisfied by setting compensation for the expropriated securities which accords with their market value; market price is not, however, decisive of fairness which must take account of "numerous factors" including the assets of the company, market value, the company's earnings and future prospects, and any other elements that affect the intrinsic or inherent value of the security.[17] Consideration of these factors may lead to the conclusion that the market price, or a higher price, is not the fair price of the shares.

The fair dealing aspect embraces questions of timing of the expropriation, how it was structured, initiated, negotiated and disclosed, and how approvals to the transactions by directors and other shareholders were obtained.[18] McHugh J said that "in the forefront" of the requirement of fair dealing is *"the necessity for the majority shareholders through the company to make a full disclosure of all matters that may affect a judgment as to the fairness of the proposed alteration"* (emphasis added); these matters will usually require disclosure of

- the purpose of the transaction;
- full reasons for rejecting alternative means of achieving that purpose;
- justification of the fairness of the compensation offered; and
- an independent valuation of the expropriated interests.[19]

Further, in "most cases" full disclosure will also require disclosure of information concerning

- the current and historical stock market prices of the shares where they are applicable;
- the net book value of the assets and the value of the company, both as a going concern and on a liquidation;
- any reports and valuations prepared in relation to the alteration; and
- any firm offers for, or serious inquiries about the purchase of, the assets of the company.[20]

15 (1995) 182 CLR 432 at 457.

16 457 A 2d 701 (Delaware Supreme Court 1983).

17 (1995) 182 CLR 432 at 457; this list of factors which may displace market price as the measure of fair value is derived from *Weinberger v UOP Inc* 457 A2d 701 (1983) at 711.

18 (1995) 182 CLR 432 at 458-459.

19 At 459.

20 At 459. These matters will need to be verified on oath if the alteration is challenged.

In contrast with the joint judges, McHugh J considered that in the present case the business objective (or purpose) underlying the alteration was proper and provided sufficient justification for the expropriation of each member's shares provided that it was otherwise fair to that member.[21] Again, in contrast with the joint judges who assumed without deciding the underlying fairness of the alteration, McHugh J held that the company had failed to prove that the expropriation was not oppressive. While it may have discharged the onus in relation to the fairness of the compensation payable, "almost no attempt was made to make the full disclosure that is required in this class of case"; accordingly, he concluded that the "evidence falls short of proving that WCP and the majority shareholders have dealt with each appellant fairly."[22]

3 Disclosure obligations emerging from the Gambotto judgments

The joint judges assumed the fairness of the expropriation on the grounds that it was not disputed by the plaintiff. However, they found that the resolution was vitiated by its underlying purpose. McHugh J reached converse conclusions, namely, that the underlying purpose was proper but that fair dealing was not established because of disclosure deficits. The scope of disclosure obligations of those who bring forward expropriatory constitutional amendments does not therefore emerge unambiguously from the judgments. Both judgments, however, assert that corporate squeezeouts effected by constitutional alteration will fail the fairness standard if they are not accompanied by all information relevant to the alteration.[23] Only McHugh J applied this standard to the instant facts; and he did so by explicit adoption of detailed and expansive norms derived from the Delaware decision in *Weinberger v UOP Inc*.

What then are the obligations to make proper disclosure to shareholders on the part of those directors or majority shareholders who convene meetings or instigate proposals leading to the elimination of minority interests? Several distinct questions arise from *Gambotto* with respect to the scope of disclosure obligations in expropriatory constitutional amendments.

- Is McHugh J, in his detailed statement of the disclosure obligations of those propounding the resolution, expressing a conception and content of those obligations shared with the joint judges but not explicated by them because they were extraneous to their decision? Put another way, what is the precedential status of McHugh J's statement of disclosure obligation?

- What is the particular and practical content of that statement of disclosure obligation? How might the standard be discharged in circumstances such as those in *Gambotto*?

- Do the disclosure regimes specified for the statutory modes of compulsory acquisition have any relevance in fixing or applying the general law standard in squeezeouts effected by constitutional amendment?

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21 At 459.

22 At 459-460.

23 At 446 and 459.

Since constitutional squeezeouts are but a particular instance of collective shareholder decision, answers to these questions will be found, if at all, in the general body of principles establishing the general disclosure standard applicable to proposals brought to shareholder meetings.

Disclosure Obligations in Relation to Shareholder Meetings Generally

The range of disclosure obligation

The general law recognises two distinct species of obligation or duty of disclosure in communications with shareholders. The first is an obligation, in framing notices of shareholder meetings, to make a sufficient statement of the objects and general nature of the meeting. A meeting is only competent to deal with business which is properly notified to members in the notice convening it[24] since it is on the basis of this notice that members make their decision as to whether to participate in the meeting.[25] The notice convening a general meeting must sufficiently specify the general nature of the business of the meeting. While the notice need not be meticulously precise, it must give a fair and reasonable intimation of what is proposed to be dealt with at the meeting.[26] Where a notice of meeting was accompanied by an independent expert's report which misstated the effect of the proposed resolutions, the notice was held to be insufficient and the resolutions set aside.[27] There is accordingly some danger in a notice of meeting, particularly one which would affect the fundamental rights of shareholders, which fails to set out the text of the proposed resolution proposing an amendment to the articles; this danger is the more egregious when explanatory memoranda circulated with the notice of the meeting do not give shareholders a full, fair or accurate account of the proposed new articles.[28]

A further obligation, arising in equity from the fiduciary nature of their office, requires directors to provide members with information material to their deliberations, at least when they are proposing or recommending support for shareholder resolutions. The case law establishing the second obligation is predominantly concerned with the fairness and clarity of directors' disclosure to the general meeting. Failure to make adequate or accurate disclosure to meetings or defects in the advice and recommendations made to shareholders may vitiate decisions taken at those meetings.

This duty bears the principal burden of defining and assuring the legitimate

24 *Holmes v Life Funds of Australia Ltd* [1971] 1 NSWLR 860; *Helwig v Jonas* [1922] VLR 261.

25 *Tiessen v Henderson* [1899] 1 Ch 861 at 870; *Devereaux Holdings Pty Ltd v Pelsart Resources NL (No 2)* (1985) 9 ACLR 956 at 958.

26 *Ryan v Edna May Junction Goldmining Co NL* (1916) 21 CLR 487 at 500; *Re London & Mediterranean Bank, Wright's Case* (1868) 37 L J Ch 529 at 537 ("fair business-like notice in the circumstances"); *Devereaux Holdings Pty Ltd v Parry Corporation Ltd* (1985) 9 ACLR 837 at 842.

27 *Devereaux Holdings Pty Ltd v Parry Corporation Ltd* (1985) 9 ACLR 837.

28 *Bancorp Investments Ltd v Primac Holdings Ltd* (1984) 9 ACLR 263.

information expectations of shareholders in relation to matters submitted to their collective decision. It is this duty which determines the disclosure standard applicable in constitutional squeezeouts such as in *Gambotto*. The duty has been developed in cases not specifically concerned with constitutional alteration much less of an expropriatory character. Nonetheless, it provides the body of principles which are the primary reference to the questions posed in *Gambotto*.

The distinction between the duty to frame proper notices[29] and the equitable duty to inform and advise members is not always easily drawn, particularly where explanatory material accompanies the notice of meeting. The distinction between the two species of obligation, and their juridical bases, is made more explicitly in recent case law.[30] Further, while some earlier cases,[31] and a recent appellate decision,[32] use the language of directors' duties to express shareholder information standards, others have looked simply to the adequacy of information available to shareholders, or its misleading tendency, without formally treating the issue in terms of directors' duties. This latter formulation clearly fits more comfortably with the characterisation of the initiative in *Gambotto* as that of a majority shareholder rather than of the directors.

The case law establishing the disclosure obligation principally concerns proposals apparently either initiated or supported by directors. The disclosure obligation is not, however, confined to director initiated resolutions and extends to material circulated by directors in response to the initiatives of others.[33] Since the focus of concern of the disclosure doctrine is with the integrity of shareholder decisionmaking, there is no reason to suggest that a differential disclosure standard would or should apply, at least as between proposals for constitutional squeezeouts, as between proposals initiated by majority shareholders and those made by directors as autonomous agents. In practice, it is directors who convene shareholder meetings, whether on their own motion or at the behest of majority shareholders. *Gambotto* is a rare decision in that the party initiating the resolution is identified as a shareholder rather than the directors. It is not clear, however, that this makes any difference to disclosure obligations and the expectations of members. For brevity, and since the case law other than *Gambotto* is substantially expressed in terms of directors' obligations, reference will be made here to directors exclusively; this reference might equally (if awkwardly) include majority shareholders initiating resolutions before the general meeting.

29 This obligation has been described as a common law duty, to distinguish it from the equitable duty to inform and advise shareholders: *Devereaux Holdings Pty Ltd v Pelsart Resources NL (No 2)* (1985) 9 ACLR 956 at 958.

30 *Chequepoint Securities Ltd v Claremont Petroleum NL* (1987) 11 ACLR 94 at 96; *Devereaux Holdings Pty Ltd v Pelsart Resources NL (No 2)* (1985) 9 ACLR 956 at 958; see generally E Magner, "Notice of Purpose of Company General Meetings: The Common Law Requirement, The Fiduciary Duty" (1987) 5 C & SLJ 92.

31 See, eg, *Bulfin v Bebarfield's Ltd* (1938) 38 SR (NSW) 424 and *Peel v London & North Western Railway Co* [1907] 1 Ch 5.

32 *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590 at 601-602.

33 See, eg, *Bain & Co Nominees Pty Ltd v Grace Bros Holdings Ltd* (1983) 2 ACLR 777.

These general law obligations are complemented by statutory remedies, principally that under s 52 of the Trade Practices Act 1974, and its counterpart in s 995 of the Corporations Law, with respect to misleading and deceptive conduct. The light which each casts upon the *Gambotto* questions is briefly explored.

The equitable duty to disclose matters material to shareholder judgment

i The nature and scope of the duty

Directors are under an equitable obligation to make full disclosure of facts within their knowledge which are material to the decision before shareholders, including whether or not to attend the meeting.[34] The obligation requires them to fully and fairly inform and instruct the shareholders upon what is proposed in the resolutions put before them; in particular, where directors take it upon themselves to urge, recommend or advise members to exercise their powers in general meeting in a particular way, they must make full disclosure of all matters within their knowledge which would enable the members to make a properly informed judgment on the matter in question.[35]

There is authority that disclosure obligations may not be limited by the boundaries of directors' extant knowledge. First, in particular instances they may be required to undertake inquiries to obtain information for communication to members; further, directors must not consciously refrain from seeking relevant information or turn a blind eye to relevant material in order to avoid placing before members information which may contradict or qualify any particular position taken or advocated by the directors or a majority of them.[36]

The obligation to give full information does not require directors to give shareholders every piece of information which might conceivably affect their voting; rather, the obligation is to indicate the information which they consider that shareholders should have, plus that information which it would be obvious to the average commercial reader that they should have.[37] Thus, disclosure was held to be inadequate when the explanation of proposed resolutions to alter the company's articles by reducing directors' discretion to refuse registration of share transfers did not inform shareholders that the proposed changes would also impose a limit upon beneficial shareholdings in the company and upon shareholders' voting rights; the text of the proposed changes was not contained in the documents distributed to members.[38]

Further, disclosure must be made in terms that do not mislead members whether by suppression of information or by what it expressly states;[39] directors will mislead

34 *Bulfin v Bebarfield's Ltd* (1938) 38 SR (NSW) 424 at 440.

35 *Bulfin v Bebarfield's Ltd* (1938) 38 SR (NSW) 424 at 440; *Chequepoint Securities Ltd v Claremont Petroleum NL* (1987) 11 ACLR 94 at 96; *Baillie v Oriental Telephone and Electric Co Ltd* [1899] 1 Ch 870; *Mott v Mount Edon Gold Mines (Aust) Ltd* (1994) 12 ACSR 658 at 662.

36 *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590 at 602.

37 *Buttonwood Nominees Pty Ltd v Sundower Minerals NL* (1986) 10 ACLR 360 at 362.

38 *Bancorp Investments Ltd v Primac Holdings Ltd* (1984) 9 ACLR 263.

39 *Devereaux Holdings Pty Ltd v Pelsart Resources NL (No 2)* (1985) 9 ACLR 956 at 958.

shareholders if they provide them with material that is other than substantially true, including explanatory material which is tricky in that its terms, while literally true, are framed to mislead readers as to their meaning or effect.[40] Shareholders are entitled to expect that the information sent to them is "fairly presented, reasonably accurate, and not misleading."[41] Breach of this obligation need not be dishonest or involve moral turpitude.[42] On the other hand, if directors make it clear that they are merely putting forward their own views or opinions, in the absence of dishonesty or trickery, they will not breach their duty if those views are objectively wrong:

> An expression of an honest opinion ... does not amount to a misrepresentation or even to inaccuracy if the opinion, even if wrong, is accurately stated as an opinion.[43]

The court looks only to whether the information provided to shareholders was capable of misleading, and does not require evidence that some particular person was induced to act by reason of non-disclosure or misstatement;[44] of course, where there is evidence that shareholders have actually been mislead, that will usually be determinative.[45]

2 Disclosure where directors derive benefits from resolution

The disclosure obligation is "particularly insistent" when directors stand to derive a benefit under the proposed resolution; where directors have an interest in the subject matter of the resolution or may derive a benefit from its passing, they must make full and true disclosure of benefits which any director may derive from the resolution.[46] Thus, where the notice convening a general meeting to approve an agreement for the sale of the company's undertaking described it simply as an agreement for sale without disclosing that the purchaser agreed to pay, in addition to the purchase price, a substantial sum to its directors as compensation for loss of their office, the company was restrained from carrying out the agreement;[47] the notice was a "tricky notice...most artfully framed to mislead the shareholders".[48] The court did not require evidence that any shareholder had been misled by the notice but acted upon its own view that the shareholders had not been sufficiently informed of the meeting's purposes.

On the other hand, a challenge to the sufficiency of disclosure failed where directors of a company which proposed to make an allotment of shares to another company

40 *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503 at 514, 515; *Jackson v The Munster Bank Ltd* (1884) 13 LR Ir 118 at 136-137; *Kaye v Croydon Tramways Co* [1898] 1 Ch 358.

41 *Goldex Mines Ltd v Revill* (1974) 54 DLR (3d) 672 at 679; *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590 at 602.

42 *Chequepoint Securities Ltd v Claremont Petroleum NL* (1987) 11 ACLR 94 at 98

43 *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 at 487-488 per Latham CJ and 514-515 per Dixon J.

44 *Shears v Chisholm* (1992) 9 ACSR 691 at 787; *Bulfin v Bebarfield's Ltd* (1938) 38 SR (NSW) 423 at 434-435.

45 As in *Re Marra Developments Ltd* (1976) 1 ACLR 470 at 479-480.

46 *Chequepoint Securities Ltd v Claremont Petroleum NL* (1987) 11 ACLR 94 at 96; *Tiessen v Henderson* [1899] 1 Ch 861; *Colhoun v Green* [1910] 1 VLR 196.

47 *Kaye v Croydon Tramways Co* [1898] 1 Ch 358.

48 Ibid at 369 per Lindley MR.

failed to disclose to shareholders convened to approve the allotment that each of the directors had been employed as consultants to the proposed allottee and that several of them were connected with another company in which the proposed allottee had a 40% interest. The challenge failed upon the ground that the association between the directors and the proposed allottee was so ephemeral that it could not be said to affect the decision of shareholders on the issue before them.[49]

3 Standards of clarity and intelligibility

The information should be in a form which is comprehensible to its readers "on the run". The expectation is that information which is provided to the ordinary reader who scans or reads it quickly will fully inform them about the matter on which they are asked to vote.[50] The characteristics of the audience will to some extent shape expected standards of clarity and expression. It is no longer the case, if it ever was, that it can be assumed that readers of company documents are necessarily conversant with business or finance; indeed, modern authority asserts that it is notorious that the class of persons who invest in companies has broadened considerably...and that a significant proportion of shareholders are not businessmen in the sense of having any special knowledge or skills in the field of business. Yet they are just as entitled to a notice that is fair and reasonable in the circumstances.[51]

Different standards of clarity, simplicity of expression and perhaps of content, might apply therefore to communications with a small and financially sophisticated shareholder group than to one with a large membership with mixed financial and business experience. Further, it is suggested below that the gravity of the matter for decision may also influence the disclosure standard in a particular instance.

The need to make full and fair disclosure must be balanced also against the need to present a document which is intelligible to its readers. Providing more information is not necessarily helpful if it is in a form or quantity which imposes an intolerable burden on its readers and is more likely to confuse than enlighten them.[52] In more complex cases therefore it may be necessary to be selective in the information that is provided, confining it to that which is realistically useful.[53] Views may differ on the application of such a broad standard.

Accordingly, in *Fraser v NRMA Holdings Ltd*[54] statements made in a prospectus to the effect that the interests of members of NRMA and its associated insurance company were "similar", while not completely correct legally, were not likely to mislead or deceive.

49 *Buttonwood Nominees Pty Ltd v Sundowner Minerals NL* (1986) 10 ACLR 360.

50 *Ryan v Edna May Junction Goldmining Co NL* (1916) 21 CLR 487 at 495; *Re Dorman Long & Co Ltd* [1934] 1 Ch 635 at 665-666; *Re Marra Developments Ltd* (1976) 1 ACLR 470; *Devereaux Holdings Pty Ltd v Pelsart Resources NL (No 2)* (1985) 9 ACLR 956 at 958-959.

51 *Re Marra Developments Ltd* (1976) 1 ACLR 470 at 479.

52 *Killen v Marra Developments Ltd* (Kearney J, Supreme Court of NSW, 5 July 1979; noted at [1979] ACLD para 608).

53 *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590 at 603.

54 (1995) 15 ACSR 590.

Similarly, the treatment of the future conduct of the undertaking after the proposed demutualisation was held not to be inadequate for failing to make a clear statement of the intentions of the newly formed holding company. In contrast, the persistent repetition of the reference to "free shares" in the document which served as the disclosure statement for the shareholder meeting considering the merger proposal was held to be likely to engender the notion that the offered shares in the new holding company might be acquired without significant loss or outgoing by erstwhile members of the merging companies.

One formulation expresses the test of sufficient disclosure in circumstances where there is no suggestion that directors are acting otherwise than honestly and to the best of their ability:

> the question is not whether the circular might have been differently framed, but whether there is any reasonable ground for supposing that such imperfections as may be found in the circular have had ... the result that [shareholders voting for the resolution] have done so under some serious misapprehension of the position.[55]

There is further authority, of significance for the questions posed in relation to *Gambotto*, that directors are not necessarily required to disclose to shareholders all the information available to the board; indeed, some latitude is said to be accorded to directors, particularly where the honesty of their judgment is not challenged.[56]

Statutory remedies with respect to misleading and deceptive conduct

Other doctrines, such as s 52 of the Trade Practices Act 1974 and its counterpart in s 995(2) of the Corporations Law, may affect disclosure obligations to shareholders in *Gambotto* situations. The *NRMA* case establishes that s 52 does not impose an independent duty of disclosure requiring directors to give any particular information to members who are asked to consider a motion in general meeting. Yet, where information is given in purported discharge of the general law duty, s 52 requires that the information given is not misleading or deceptive or likely to mislead or deceive.[57] The principal impact of s 52 upon disclosure to general meetings is more likely to arise in respect of what is not communicated to shareholders. This failure to disclose may, of course, breach the general law obligation on the grounds that what has been disclosed is incomplete or misleading (see above) as well as contravene ss 52 and 995(2). Thus, while these sections do not in terms impose a duty of disclosure, unless the information which is given "constitutes a full and fair disclosure of all facts which are material to enable members to make a properly informed decision, the combination of what is said and what is left unsaid may be likely to mislead or deceive members."[58] Unlike the general law duty of disclosure, a contravention of s 52 may occur even if directors did

55 *Re Imperial Chemical Industries Ltd* [1936] 1 Ch 587 at 618; aff'd sub nom *Carruth v Imperial Chemical Industries Ltd* [1937] AC 707 at 768; *Re Castlereagh Securities Ltd* [1973] 1 NSWLR 624 at 636; *Bain & Co Nominees Pty Ltd v Grace Bros Holdings Ltd* (1983) 7 ACLR 777 at 781.

56 *Shears v Chisholm* (1992) 9 ACSR 691 at 779.

57 *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590 at 602.

58 Ibid.

not have knowledge of the undisclosed facts which rendered the conduct in breach of s 52, that is, the contravention may occur without knowledge or fault on the part of the corporation and despite the exercise of reasonable care on the part of its directors.[59]

Review of Disclosure Issues Posed by Gambotto

How then are we to respond to the questions posed above relating to the disclosure obligations of those bringing proposals for constitutional amendment leading to or effecting the elimination of minority interests?

The status of the elements of disclosure identified by McHugh J

What is the precedential status of McHugh J's statement of disclosure obligation? The general formulations of the duty of disclosure to shareholders adopted in the joint judgment (viz, "all relevant information leading up to the alteration") and by McHugh J ("all matters that may affect a judgment as to the fairness of the proposed alteration") are both consistent with settled formulations of the equitable obligation of disclosure. Both judgments, however, eschew reference to that body of authority in favour of reference to one or two North American decisions.[60]

Does the detailed statement by McHugh J of the disclosure obligations of those propounding the resolution express a conception and content of those obligations which is shared with the joint judges but not explicated by them because it is extraneous to their decision? That is a more difficult question, but an important one. The mandatory status of several of the matters which are said to be required to be disclosed "usually" or in "most cases" rests more or less comfortably with the general body of equitable doctrine; few, if any, of such cases, however, concern resolutions of the compulsory acquisition of minority interests. These matters might include information concerning the purpose of the transaction, justification of the fairness of the compensation offered, any reports and valuations prepared in relation to the alteration and any firm offers for, or serious inquiries about the purchase of, the assets of the company.

On the other hand, several other matters identified by McHugh J may enjoy a less secure status as items for mandatory disclosure at general law. These include the requirement of full reasons for rejecting alternative means of achieving the purpose of the transaction, an independent valuation of the expropriated interests, the current and historical stock market prices of the shares, and the net book value of the assets and the value of the company, both as a going concern and on a liquidation. These items are perhaps less clearly supported by previous authority as mandatory disclosure items although there is authority supporting a disclosure standard whose exactions are responsive to the novelty and complexity of the transaction.[61] Equally, there is much to

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59 Ibid.

60 *Re John Labatt Ltd* (1959) 20 DLR (2d) 159 (British Columbia Supreme Court); *Weinberger v UOP Inc* 457 A2d 701 (Delaware Supreme Court 1983).

61 *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590 at 604; *Fraser v NRMA Holdings Ltd* (1994) 12 ACLC 855 at 869 (Gummow J).

be said in principle for the burden of disclosure to vary with the significance of the collective decision for individual members. If it does, of course, the disclosure standard would be close to its most exacting demands in relation to resolutions such as that passed in *Gambotto*.

One point of explicit agreement between the joint judges and McHugh J is that the majority shareholder bears the onus of establishing the fairness of the expropriatory alteration.[62] In contrast, the onus is upon the shareholders seeking to invoke remedies under general law duties of disclosure and under s 52 of the Trade Practices Act.[63] It may be that the significance of the expropriatory alteration for those against whom it is invoked displaces the burden under the general rule. Since neither judgment referred to authorities under general law disclosure doctrines, the precise basis for this departure from their rule is speculative.

What does this statement of disclosure obligation require?

How might a company satisfy the *Gambotto* standard? Is slavish observance of McHugh J's disclosure list sufficient even if (depending on the answer to questions posed under the previous heading) it is not necessary? What principles underlie these elements?

1 *Balance in presentation of arguments*

Even if both sides of the proposal do not have to be canvassed - and it is not clear that McHugh J's list includes such an item - there is a more basic principle which requires a balanced explanation or presentation of the arguments for and against the proposal, at least where it is controversial or disputed, or its impact uneven or discriminatory. That requirement is perhaps closer to the grundnorm of the disclosure obligation. Directors may apply company funds for the distribution of circulars explaining and, indeed, advocating particular proposals put to members.[64] They are not, however, obliged to do so. In his first instance judgment in the *NRMA* case, Gummow J supported the distribution of written reasons advanced by those dissenting from the position taken by the board or majority shareholders as "a practical and effective means" of equipping members to make a decision and to avoid their being mislead by inadequate disclosure.[65]

2 *Application in Weinberger v UOP Inc*

The list of mandatory disclosure items adopted by McHugh J is derived, it has been noted, from the decision of the Supreme Court of Delaware in *Weinberger v UOP Inc*. That decision provides some insight into their application. The parent company of a

62 (1995) 182 CLR 432 at 447 and 459.

63 See, eg, *Fraser v NRMA Holdings Ltd* (1995) 15 ACSR 590 at 603.

64 *Peel v London & North Western Railway Co* [1907] 1 Ch 5; *Campbell v The Australian Mutual Provident Society* (1906) 1 SR (NSW) 89, aff'd (1908) 24 JLR 623 (PC); directors may not, however, apply such funds to solicit support for their re-election: *Advance Bank Aust Ltd v FM Insurances Ltd* (1987) 9 NSWLR 464.

65 *Fraser v NRMA Holdings Ltd* (1994) 12 ACLC 855 at 869.

subsidiary with a minority outside interest acquired the remaining shares in the subsidiary by a merger transaction involving the payment of cash to minority shareholders for their shares. A minority shareholder challenged the validity of the merger transaction and sought to set it aside upon the basis that it did not meet the tests of fairness.

The court accepted that the concept of fairness has two basic aspects: fair dealing and fair price. These twin aspects were, as has been noted, adopted by McHugh J. The court accepted that the test for fairness was not a bifurcated one as between fair dealing and price, and that "all aspects of the issue must be examined as a whole since the question is one of entire fairness."[66] The court held that the merger did not meet the test of fairness since the feasibility study prepared by two of the subsidiary's directors, who were also directors of the parent company, had indicated that a price in excess of what the parent ultimately offered for the subsidiary's outstanding shares would have been a good investment for the parent, and was not disclosed to the subsidiary's outside directors.

There are special features in this decision. First, there were "obvious conflicts" posed by the preparation of this report by the parent company's nominees upon the subsidiary board, particularly since it was derived from information as to the subsidiary utilised for the sole use and benefit of the parent. The court also drew attention to the rush and haste with which a "rather cursory opinion" as to fairness was prepared by an investment banker. This haste was attributable to the timetable for the transaction generated by the parent which haste was not disclosed to the minority shareholders in the subsidiary although the impression was given that a careful study had been made by the investment bank.

The significance of the disclosure regimes for the statutory modes of compulsory acquisition

Do the disclosure regimes specified for the statutory modes of compulsory acquisition have any relevance in fixing or applying the general law standard in squeezeouts effected by constitutional amendment? It is perhaps a question for future decisions to decide whether the rather variegated pattern of disclosure applying across the several modes of statutory compulsory acquisition provides a set of principles or at least of gap fillers in relation to fixing the disclosure standard applicable to constitutional squeezeouts. It is possible of course that the more integrated disclosure system that is emerging in the Corporations Law with respect to fundraising, continuous disclosure, insider trading and the Part A requirements for scrip offers under take-over schemes will provide a sounder and more enduring foundation for disclosure requirements of minorities in squeezeouts. The two bodies of disclosure obligation follow different principles and while it may be thought that the compulsory acquisition provisions are directly relevant as guidance on proper disclosure, there is much to commend the integrated disclosure system as a coherent and consistent model of a disclosure scheme.

66 457 A2d 701 at 711.

A more interesting question perhaps, and the converse of that just posed, is whether the elevation of disclosure obligations in *Gambotto* will have an effect upon the operation of disclosure under statutory modes of compulsory acquisition. That outcome is not suggested by the High Court. Neither can it be entirely eliminated as a consequence of the decision in *Gambotto*.

Chapter 4

The Implications of Gambotto for Non-Takeover Aspects of Compulsory Acquisitions: A Comment

Quentin Digby[1]

There are a variety of methods by which shares can be compulsorily acquired without relying on the formal statutory procedures in sections 701 and 414 of the Corporations Law. The implications of the *Gambotto* judgment[2] on the alternative methods vary greatly.

I propose to focus my comments on two issues:

- **selective capital reductions** -

  one of the most prevalent methods of compulsory acquisition in recent years; and

- **demutualisations** -

  in particular, the implications for demutualisations which rely on amendments to the company's articles to remove non-shareholder members, as was proposed by NRMA.

I will also touch on methods of compulsory acquisition for which *Gambotto* will be of limited relevance, including Schemes of Arrangement.

Selective Capital Reductions

If you had canvassed the views of commercial lawyers in 1990 as to whether minority shareholders could be eliminated by a selective capital reduction, it is likely that most of those canvassed would have said "No - the Court would not confirm such a Scheme". However, in the intervening years there has been a series of decisions where the Court has been willing to confirm such a selective capital reduction *provided* the Court is satisfied that the minority shareholders will receive a fair price.

The s195 capital reduction procedure is remarkably simple when compared to the statutory compulsory acquisition procedures. The company seeks a special resolution

1 Partner, Freehill Hollingdale & Page.

2 *Gambotto v WCP Limited* (1995) 182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243.

of its shareholders to cancel the shares held by the minority interests in exchange for a cash payment (usually funded by the majority shareholder). Under the current law, it is then necessary to obtain Court confirmation of the capital reduction. However, there is no statutory requirement for class meetings or for the majority shareholder to abstain from voting. Nor is there a statutory requirement for an independent expert's report or for any formal disclosure document, beyond an adequate notice of meeting.

In practice, all of these safeguards are voluntarily complied with. They amount in effect to a closely followed "code of best practice". Even before the ASC adopted a policy embodying these safeguards [Practice Note No 29] it was generally accepted that adherence to this best practice approach was important to the company's ability to demonstrate to the Court (at the time of seeking the Court's confirmation) that the reduction is "fair" to the minority shareholders whose shares are being cancelled.

Interestingly, the High Court chose not to refer to the recent line of selective capital reduction cases, despite their obvious relevance to the question before the Court in *Gambotto*. What is clear is that the High Court was motivated by a concern that if the Court permitted a *Gambotto* style "expropriation" it would render superfluous the various statutory methods of compulsory acquisition, most notably, sections 701 and 414. The statutory procedures, including schemes of arrangement, have built-in procedural requirements which protect minority interests. In the words of the joint judgment, to allow expropriation of the minorities' shares by way an amendment to the Articles:

> would open the way to circumventing the protection which the Corporations Law gives to minorities who resist compromises, amalgamations and reconstructions, schemes of arrangement and takeover offers.[3]

What are the ramifications of the *Gambotto* decision for selective capital reductions which are designed to expropriate the minorities' shares?

The High Court's comment in the quote above was directed towards Chapters 5 and 6 of the Corporations Law and not selective capital reductions. Nevertheless, for so long as a capital reduction requires the Court's confirmation and the Court retains a wide discretion not to confirm the reduction if it is "unfair" to the minority, it seems logical that selective capital reductions should remain open as a viable method of eliminating minority holdings after *Gambotto*. The High Court refrained from casting doubt on the recent line of selective capital reduction cases and this is entirely consistent with a view that section 195, through the requirement for Court confirmation, embodies an adequate procedural requirement for the protection of minority interests.

Practitioners should, however, note three points:

1. The recent Corporations Law simplification proposals,[4] suggest that the Law may be amended to eliminate the need for Court confirmation of capital

3 Ibid at 446.

4 Second Corporate Law Simplification Bill, Exposure Draft, June 1995.

reductions. This may be a welcome reform. However, for the purposes of compulsory acquisitions, such an amendment to the Law will result in *Gambotto* becoming directly relevant to selective capital reductions in the future.

2. Even if the Court confirmation requirement remains in section 195, if a Scheme of Arrangement or one of the two statutory compulsory acquisition procedures is a feasible alternative in the circumstances, such a procedure will, in light of *Gambotto*, be preferred by conservative practitioners, at least until the validity of selective capital reductions (to eliminate minority holdings) is again confirmed by an appropriate judicial authority.

3. As an aside, there is another recent decision relating to selective capital reductions which may prejudice the future effectiveness of this method of eliminating minority interests. In fact, the decision of McLelland CJ in *Melcann Ltd v Super John Pty Ltd*,[5] has potentially far reaching implications for *all* compulsory acquisition procedures. In reading his judgment, one senses that McLelland CJ was frustrated by the need to follow the line of cases before him, all of which had upheld the validity of this method of compulsory acquisition. It is perhaps no coincidence that his Honour was also the judge at first instance in the *Gambotto* case itself.

   I can only assume that the supporters of the selective capital reduction in respect of Melcann Limited believed that they had "covered all the bases" by voluntarily adopting the best practice procedures outlined above. They were wrong. McLelland CJ dismissed the application for Court confirmation on the basis that the independent expert's report, in assessing the fairness of the payment to the minority holders, failed to take into account the special benefits which would flow to the majority shareholder upon Melcann becoming a wholly owned subsidiary. These benefits, in his Honour's view, should have been taken into account in determining the "fair value" of the shares to be cancelled even though they could only be derived by the holder of 100% of the shares in the company.

   With the greatest respect, I find this judgment troublesome. It is not clear from McLelland CJ's judgment whether the benefit accruing to the majority is to be spread evenly across all of the shares in the company or simply to the shares held by the minority. The latter result would be perverse because the minorities' shares would continue to become more valuable as they were progressively eliminated. Indeed, it would remove any commercial justification for the proposal in the first place! Even if the benefits are spread across the whole of the issued share capital, the decision still runs counter to principles previously laid down in *Catto v Ampol Ltd*.[6] All shareholders should be treated equally. Just as the "rump" of minority shareholders left after a takeover should not receive less than those who accepted the offer, nor should they be entitled to receive more

5 (1994) 13 ACLC 92.
6 (1989) 16 NSWLR 342.

than what can objectively be determined to be a fair price for the shares in *their* hands.

Demutualisations

Turning to the proposed NRMA demutualisation, it has been interesting to observe the apparent consensus of authority, as quoted in the media, that the *Gambotto* decision rules out any possibility of effecting a demutualisation by means of an alteration to the Articles. I am not at all persuaded that *Gambotto* is applicable to demutualisations. The two situations are, in my opinion, quite distinct.

The High Court's "elevated proper purpose" test was conceived in respect of circumstances where the majority was using its voting power to introduce an expropriation Article which would enable expropriation of minority interests for the "aggrandisement of the majority". In these circumstances, it was not sufficient for the majority to argue that the expropriation was in the interests of the company. The fact that the company derives an advantage from the expropriation is of little comfort to the former minority holders who no longer enjoy any interest in the company and cannot therefore participate in the relevant advantage. In the joint judgment, the Court said:

> To allow expropriation where it would advance the interests of the company as a legal and commercial entity or those of the general body of corporators would, in our view, be tantamount to permitting expropriation by the majority for the purpose of some personal gain and thus be made for an improper purpose.[7]

The *Gambotto* decision confirms the equitable principle that a power to amend Articles, in a way which allows a majority shareholder or group of shareholders to expropriate shares held by minority interests, is subject to implied limitations. In *Peters' American Delicacy Company v Heath*,[8] Dixon J had rejected the traditional "interests of the company as a whole" proper purpose test where an amendment to Articles gives rise to a "conflict of interests and advantages". Likewise, in *Gambotto*, the High Court stated that if a conflict of interests and advantages exists, an expropriation provision could not be introduced into the Articles simply for the purpose of obtaining an advantage for the company because to do so merely "aggrandised" the majority.

Where is the conflict of interests and advantages when a demutualisation is implemented by an amendment to the Articles which results in *all* members losing their membership rights in exchange for the opportunity to receive shares (in either the mutual or a new holding company)? Such an amendment will not result in any "aggrandisement" of a "majority" to the exclusion of a minority. All former members of the mutual company continue to have the right to participate in the fortunes of the company by becoming shareholders in either the company or in a new holding company. More importantly, all members are treated equally. There is nothing analogous to a majority member who

7 (1995) 182 CLR 432 at 446.

8 (1939) 61 CLR 457.

reaps the benefits of the restructuring to the exclusion of the members eliminated.

In the context of an NRMA proposed style of demutualisation, the conflict of interests and advantages which attracts the equitable principle underlying the *Gambotto* case is absent. If an amendment to the Articles does not expressly or implicitly (as a result of the relevant circumstances) discriminate against a "minority" and all the members are afforded the opportunity to continue to participate in the company's fortunes, it should be sufficient that the amendment is designed to give rise to proper commercial advantages for the company and its members. Nothing in the *Gambotto* decision suggests that a higher "standard" is required where there is no "conflict of interests or advantages".

Schemes of Arrangement

Turning now to Schemes of Arrangement, a Scheme is one method of compulsory acquisition for which *Gambotto* has very limited ramifications. The quote to which I referred earlier makes it clear that the High Court considers Schemes of Arrangement, like takeovers, to be in an entirely different category. The statutory Scheme procedure has built-in protections for minority interests.

However, the High Court's decision is likely to have some impact on the nature and quality of the disclosure which is provided in the explanatory statement sent to members. Coming hard on the heels of the Federal Court decision in the *NRMA Case*, it is clear that extra effort is now required in respect of any restructuring where there is an expropriation of rights. The company must ensure that the disclosure document provided to members is accurate, clear and complete. A description of possible alternatives and the reasons for selecting the specific proposal being put to members is likely to become standard content. Disclosure obligations are considered in detail in Chapter 3 of this book.

Other Alternative Methods of Compulsory Acquisition

I can mention in passing that some methods of eliminating minority interests are entirely immune from the *Gambotto* decision. For example, in appropriate circumstances, it remains possible for the Board to put the business undertaking up for auction. The majority shareholder can bid for the business, comfortable in the knowledge that if it pays more than a fair price, the bulk of any "premium" price will flow back to it through its majority shareholding. Of course, in most situations such a method may give rise to taxation and stamp duty disadvantages.

The Future

As a closing comment, I would like to repeat what I have said on a number of occasions.[9] The need for a controlling shareholder to resort to *Gambotto* style expropriation Articles (and for that matter to selective capital reductions) in order to

9 See, eg, Q Digby, "Eliminating Minority Shareholdings" (1992) 10 C&SLJ 105.

realise the commercial advantages of 100% ownership, is symptomatic of a defect in the Corporations Law. As is the case in many other jurisdictions, the Corporations Law should be amended to facilitate compulsory acquisition, provided the minority receives a fair price and is provided with full disclosure by which to judge whether the price received *is* fair. The statutory procedures protecting minority interests should not give them an effective power of veto over compulsory acquisitions, particularly in circumstances where they hold less than 10% of the issued capital.

Chapter 5

The Implications of Gambotto for Takeovers: A Comment

Ian Renard[1]

In this brief comment I consider the ways in which the decision of the High Court in *Gambotto v WCP Limited*[2] increases the possibility of a minority shareholder resisting compulsory acquisition under sections 414 or 701 of the Corporations Law and also increases the possibility of an offeror having a target company restrictive article declared invalid.

Increases the Possibility of a Minority Shareholder Resisting Compulsory Acquisition Under Section 414 or 701

The *Gambotto* judgment is not directly relevant to compulsory acquisitions. The Court in part justified the tough stance it took on the validity of an expropriation article because the Corporations Law provides express procedures in sections 414 and 701 for compulsory acquisition following a successful takeover.

However, a number of cases referred to by the High Court are takeover compulsory acquisition decisions and some clues can be gleaned on how the Court might approach such a case in future. The High Court has twice dealt with compulsory acquisition: *Australian Consolidated Press Ltd v Australian Newsprint Mills Holdings Ltd*[3] and *Colonial Sugar Refining Co Ltd v Dilley*.[4] The latter of the two decisions was affirmed by the Privy Council in *Blue Metal Industries Ltd v Dilley*.[5] None of these decisions is referred to in *Gambotto*.

Dissenting shareholders who have tried to resist compulsory acquisition have been consistently unsuccessful over the years. The only circumstance in which the scales have been tipped in their favour has been where it has been shown that a majority of the shareholders who accepted the offer were in some way connected with the offeror (see *Re Bugle Press Ltd*;[6] *Re Rees Application*;[7] *Esso Standard (Inter-Ameria) Inc v J W*

1 Partner, Arthur Robinson & Hedderwicks.
2 (1995) 182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243.
3 (1960) 105 CLR 473.
4 (1967) 116 CLR 445.
5 (1969) 117 CLR 651.
6 [1961] Ch D 270.
7 [1972] QWN 47.

Enterprises Inc[8]) or there has been some procedural flaw in the compulsory acquisition procedures (eg *Re John Labatt Ltd*[9]).

The Court commences with the presumption that if 90% or more of the shareholders accepted, the Court will be most reluctant to hold that the offer was unfair (*Elkington v Shell Australia Ltd*;[10] *Re Hoare & Co Ltd*[11]).

However, the *Gambotto* decision indicates that the High Court would be more likely than courts in some earlier decisions to refuse compulsory acquisition if there had been less than full disclosure. All members of the High Court emphasise the need for disclosure of all relevant information prior to alteration of the article, and in doing so all refer to a 1959 decision of a single judge of the British Columbia Supreme Court, *Re John Labatt Ltd*[12] which was one of those rare cases in which a takeover compulsory acquisition notice was held to be ineffective. It is cited with approval by the majority and by McHugh J.[13] This is rather unusual for three reasons. First, that part of the judgment in *Labatt* was only dicta. Second, that dicta has not been followed in at least one subsequent Canadian decision (*Re Dad's Cookie Co (BC) Ltd*[14]). Third, if the High Court wanted to cite authority for the proposition that a notice of general meeting proposing an amendment to Articles should contain all relevant information, there was more directly relevant Australian authority available (eg *Butterwood Nominees Pty Ltd v Sundowner Minerals NL*[15] and all the cases discussed in *Shears v Chisolm*[16] and in *Mott v Mount Edon Gold Mines (Aust) Ltd*[17]). Issues relevant to disclosure are discussed in more detail in Chapter 3.

It is also possible that the Court's basic philosophical approach to compulsory acquisition may diverge from that previously taken by Australian and English courts. The High Court in 1960 construed compulsory acquisition provisions quite liberally as "commercial rather than juristic" rules - *Australian Consolidated Press Ltd v Australian Newsprint Mills Holdings Ltd*.[18] That phrase was subsequently embraced by the English Courts (*Re Simo Securities Ltd*[19]). Australian cases since then have refuted any presumption to read the provisions narrowly because property rights are being expropriated (see particularly *TNT Ltd v NCSC*,[20] but also *Eddy v WR Carpenter*

8 [1963] SCR 144.
9 (1959) 20 DLR (2d) 159.
10 (1993) 11 ACSR 583 at 593.
11 [1953] 1 All ER 105 at 107.
12 (1959) 20 DLR (2d) 159.
13 (1995) 182 CLR 432 at 446 and 459.
14 (1969) 7 DLR (3d) 243 at 252.
15 (1986) 10 ACLR 360.
16 (1992) 9 ACSR 691 at 780-6.
17 (1994) 12 ACSR 658 at 662.
18 (1960) 105 CLR 473.
19 [1971] 1 WLR 1455 at 1464.
20 (1986) 11 ACLR 59.

Holdings Ltd;[21] *Brierley v Dextran Pty Ltd*[22] and *Elkington v Shell Australia Ltd*[23]).

Could all this now change? The High Court emphasised "the proprietary nature of a share" and disagreed with English authority to the extent that it may be thought not to endorse that emphasis.[24] They seemed very much taken by the takeover decision of *Re Bugle Press Ltd* (referred to earlier) which was based on "the fundamental legal principle that prima facie, if a person has a legal right which is an absolute right, then that person can deal with that right as he or she pleases".[25] This may indicate that if a case under s 701 or s 414 comes before the Court, the dissident shareholder may receive a more sympathetic hearing than that received in such cases as *Re Hoare & Co Ltd*.[26]

One long-running issue is what evidence does a dissenting shareholder have to address to show that the offer terms are unfair. In a number of cases it has been held that if 90% or more of other target shareholders have accepted the offer and the offer price exceeds the Stock Exchange price prior to announcement of the offer, the Court will not accept evidence from witnesses that the offer price was unfairly low (*Re Grierson Oldham & Adams Ltd*;[27] *Re The Young Roller Flour Mill Co Ltd*[28]). This is particularly the case if the offeror already controlled the target when the offer was made so that no "control premium" was payable (*Eddy v WR Carpenter Holdings Ltd*[29]).

The classic statement of this approach is found in the judgment of Vaisey J in *Re Sussex Brick Co Ltd*:[30]

> The applicant is faced with the very difficult task of discharging an onus which is undoubtedly the heavy one of showing that he, being the only man in the regiment out of step, is the only man whose views ought to prevail

It was this view that Holland J of the New Zealand High Court was upholding in *Re Sheldon*[31] when he said a court would rarely be satisfied that a price substantially higher that the Stock Exchange price was unfair.

Yet McHugh J specifically criticised that view and suggested it should not be followed in Australia.[32] The majority's criticism is only slightly more muted. After referring to *Re Sheldon*, they emphasise that a shareholder's interest cannot be valued solely by the current market value of the shares. Whether the price offered is fair depends on a variety of factors, "including assets, market value, dividends, and the nature of the

21 (1985) 10 ACLR 316.
22 (1990) 3 ACSR 455.
23 (1993) 11 ACSR 583 at 587.
24 (1995) 182 CLR 432 at 446.
25 Ibid at 443.
26 [1933] 1 All ER 105.
27 [1968] Ch 17.
28 (1977) 3 ACLR 4 at 5-6.
29 (1985) 10 ACLR 316.
30 [1961] Ch 289 at 292.
31 (1987) 3 NZCLC 100,058.
32 (1995) 182 CLR 432 at 458.

corporation and its likely future".[33]

It is perhaps a pity that the High Court ignored the long line of decisions of which *Re Sheldon* was but the latest. However, there is a clear indication that in a compulsory acquisition case under the takeover provisions, the Court would not dismiss out of hand evidence that the "real worth" of the dissentient's shares is far more than recent Stock Exchange market prices.

Increases the Possibility of an Offeror Having a Target Company Restrictive Article Declared Invalid

Unlisted target companies may have Articles which makes takeovers either very difficult or impossible. Examples are:

- restrictions on foreign persons acquiring more than a set percentage (see eg *Equiticorp Industries Ltd v ACI International Ltd*[34])
- restrictions on any person holding, or having a relevant interest in more than, a set number of shares.

In the latter category, the offeror is compelled to include as a condition of the offer that the Articles are amended before the offer expires (as in *Westel Co-Operative Ltd v Foodland Australia Ltd*[35]) or to attempt to have the offending Article declared invalid. Indeed there may be claim and counter-claim as the directors try to divest the offeror of his shares under the Article, and the offeror tries to have the relevant Article declared invalid.

Two cases demonstrate the dilemma which the Court has faced in this situation. In *Shears v Phosphate Co-operative Co of Australia Ltd*[36] the Full Court of the Supreme Court of Victoria declared the Article invalid (and thus attempts to divest the prospective offeror were invalid). The reasons for this conclusion were:

- the Article introduced on 13 February 1987 had not been passed bona fide for the benefit of the company as a whole
- the Article was oppressive of the plaintiff under the predecessor of s 260 of the Corporations Law
- the Article had two particular flaws:
  - the onus was on a shareholder to satisfy the Board that no one else had a relevant interest in the shares (extremely difficult)
  - if someone else did have a relevant interest, that person could vote at general meetings (even though not a member) and the registered holder could not.

33 Ibid at 447.
34 [1987] VR 485.
35 (1987)12 ACLR 60.
36 (1988)14 ACLR747, 7 ACLC 812.

In *Foodland Associated Ltd v Garina Pty Ltd*[37] the Supreme Court of Western Australia upheld the validity of the Articles (introduced on 8 October 1985) and the validity of the divestiture of shares. *Shears* case was distinguished on the basis that

- the plaintiff did not plead oppression
- the Article did not contain either of the fatal flaws referred to above
- there is no principle that an Article is void for uncertainty if it incorporates the concept of "relevant interest" from the Corporations Law.

How do the Shears and Foodland Cases Stand up Following Gambotto?

Neither of the cases is referred to in the High Court's judgment. On the face of it, the result in *Shears* is consistent with the *Gambotto* decision. But the High Court rejects one of the primary tests used in *Shears* (was the Article passed in the interests of the company as a whole). The terms of the High Court's rejection of the test is not confined to expropriation Articles:

> In the context of a special resolution altering the articles and giving rise to a conflict of interests and advantages, whether or not it involves an expropriation of shares, we would reject as inappropriate the "bona fide for the benefit of the company as a whole" test of Lindley MR in *Allen v Gold Reefs of West Africa Ltd*. The application of the test in such a context has been criticised on grounds which, in our view, are unanswerable. It seems to us that in such a case not involving an actual or effective expropriation of shares or of valuable proprietary rights attaching to shares, an alteration of the articles by special resolution regularly passed will be valid unless it is ultra vires, beyond any purpose contemplated by the Articles or oppressive as that expression is understood in the law relating to corporations.[38]

The Court then states that where the Articles are amended to confer upon the majority power to expropriate the shares of a minority, that a power can be taken only if:

> (i) it is exercisable for a proper purpose and (ii) its exercise will not operate oppressively in relation to minority shareholders. In other words, an expropriation may be justified where it is reasonably apprehended that the continued shareholding of the minority is detrimental to the company, its undertaking or the conduct of its affairs - resulting in detriment to the interests of the existing shareholders generally - and expropriation is a reasonable means of eliminating or mitigating that detriment.[39]

37 (1989) 15 ACLR 530; 7 ACLC 866.
38 (1995) 182 CLR 432 at 444.
39 Ibid at 445.

Both sides in *Shears* could draw comfort from *Gambotto*. That decision emphasises that expropriation articles are very vulnerable to attack. But the Board of Phosphate Co-op could argue that their defence falls within the exceptions recognised by the High Court. In a subsequent unsuccessful claim by Shears against the Phosphate Co-op directors for damages, it was held that the amendment to the Articles was proposed by the Board and their supporters bona fide in the belief that it was in the best interests of Phosphate. It was seen as closing a loophole and preserving the long-standing limitation on the maximum number of votes any one shareholder could exercise. This restriction was an essential part of preserving the company as a co-operative and maintaining the tax advantages that entailed (*Shears v Chisolm*[40])

Is that a sufficient reason to justify the Article? Clearly it would meet the test proposed by McHugh J (who thought a $4 million tax saving justified expropriation, though he held for Gambotto because WCP did not prove it had acted fairly to Gambotto[41]). The majority said "financial and administrative benefits" are not enough.[42] But in Phosphate Co-op the whole status of the company as a co-operative was at stake - the amendment may meet the majority's test of securing the company "from significant detriment or harm".[43]

In *Foodland*, the plaintiff would surely now plead oppression, but the very arguments I have just mentioned would also have been available to the Foodland Board.

40 (1992) 9 ACSR 691 at 722.

41 (1995) 182 CLR 432 at 459.

42 Ibid at 448.

43 Ibid at 445.

Chapter 6

The Implications of Gambotto for Minority Shareholders

Dr Elizabeth Boros[1]

In examining the implications of *Gambotto*'s case,[2] I plan to focus on three issues:

1. The test to be applied when the validity of an alteration of company articles is challenged.
2. Whether interested shareholders can vote on a resolution to alter the articles.
3. The relationship between the common law and the statutory remedy against oppressive or unfairly prejudicial conduct in section 260 of the Corporations Law.

But first it is worth putting these questions into context.

Background

The facts of *Gambotto* are outlined in Chapter 1. The result was that Mr Gambotto successfully challenged an alteration to the articles of association which would have enabled his shareholding to be compulsorily acquired.

The most direct implication of the case for minority shareholders is that it severely restricts the potential for minority shareholdings to be compulsorily acquired by amendment to a company's articles of association. There are, of course, other ways in which minority shareholdings can be compulsorily acquired. An express statutory power to acquire the shares of dissenting shareholders exists where a takeover has been substantially successful. Minority shareholdings may also be acquired under a scheme of arrangement or by a selective reduction of the company's capital. The implications of *Gambotto* for compulsory acquisition by these other methods are discussed in Chapters 2 to 5.

As mentioned, the first issue which I propose to consider is the test which is to be applied when the validity of an alteration of company articles is challenged.

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1 Senior Lecturer, Faculty of Law, The University of Melbourne.

2 *Gambotto v WCP Limited* (1995)182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243.

The Test for Validity of an Alteration of Articles of Association

Prior to *Gambotto*'s case, the test by which such resolutions were judged could be traced back to a dictum of Lindley MR in 1900 in the case of *Allen v Gold Reefs of West Africa Ltd*,[3] and was whether the resolution was passed "bona fide for the benefit of the company as a whole". This test had long been regarded as problematic and Dixon J, in the leading Australian case of *Peters' American Delicacy Co Ltd v Heath*,[4] interpreted Lindley MR's reference to the benefit of the company as a whole in *Allen's* case as "a very general expression negativing purposes foreign to the company's operations, affairs and organizations".[5]

The majority of the High Court in *Gambotto* took this approach one stage further, and expressly rejected the "bona fide for the benefit of the company as a whole" test as inappropriate to a resolution giving rise to a conflict of interests and advantages between majority and minority shareholders. Such resolutions would be valid unless they were ultra vires, beyond any purpose contemplated by the articles, or oppressive.

Secondly, the majority of the High Court placed resolutions involving an actual or effective expropriation of shares or of valuable proprietary rights attaching to shares in a special sub-category of resolutions giving rise to a conflict of interests and advantages. In relation to these resolutions, the onus is on the majority shareholders to establish that:

* the resolution would secure the company from significant detriment or harm (so that a future benefit in the form of taxation or administrative savings would not be sufficient); and
* both the process and the terms of the acquisition were fair.

Proper purpose

The majority judges gave as examples where expropriation could be justified, the case of a shareholder competing with the company, and the case where a shareholder's continued membership of the company prevented it complying with a regulatory regime governing its principal business.

Fairness

As regards "oppression" the majority judges held that this involved both procedural and substantive elements. Procedurally, the majority shareholder must disclose all relevant information leading up to the alteration, and presumably have the shares valued by an independent expert. In terms of substantive elements, all five Justices stated that although market price would be an influential guide to fair value, this would also depend on factors such as assets, market value, dividends and the nature of the corporation and its likely future.

3 [1900] 1 Ch 656 at 671

4 (1939) 61 CLR 457.

5 Ibid at 512.

Application

Although the decision of the majority of the High Court can be expressed relatively simply, it becomes less straightforward if one attempts to fit previously decided cases within this framework. For example, the *Peters' American Delicacy* case involved a resolution to alter the articles so that bonus shares would be distributed in proportion to the amount paid up on shares rather than in proportion to the number of shares held. The alteration therefore disadvantaged partly-paid shareholders. The case clearly gave rise to a conflict of interests between majority and minority shareholders. But did it involve an expropriation of proprietary rights attaching to shares? If it did not, then[6] the resolution would be valid provided it was not ultra vires, passed for an improper purpose or oppressive. The more stringent test for a valid expropriation could never be satisfied in this situation, since the resolution did not affect the company's interests at all, it simply adjusted shareholders' rights.

The resolutions which were to have been put to members in the NRMA case are also difficult to categorise. The proposal was to demutualise the corporations forming the NRMA, by changing their status and issuing so-called "free shares" in a new holding company to members in exchange for membership of NRMA Ltd and NRMA Insurance Ltd. The effect of these resolutions on members would have been non-discriminatory in the sense that no group would have benefited at the expense of another. Should the resolutions therefore be categorised as resolutions which did not give rise to a conflict of interests and advantages between shareholders or, will this only be the case where resolutions are passed unanimously? If the resolutions can be so categorised on the basis that all shareholders will be treated in the same way, by what test is the validity of the resolutions to be judged? The High Court did not lay down a test to cover this situation, but it could be argued that the bona fide for the benefit of the company test may continue to have an operation in such situations.

Can Interested Shareholders Vote?

The majority of the High Court expressly left open the question of whether interested shareholders could vote on a resolution to alter the articles, saying "whether it [that is, fairness] also requires the majority shareholders to refrain from voting on the proposed amendment is a question that is best left open at this stage." Although McHugh J went into the question of fair price and fair dealing in much greater detail than the majority judges, his Honour did not address this issue at all.

Thus the High Court appears to have side-stepped any resolution of the conflict between (on the one hand) the principle that a share is a right of property, and that shareholders owe no fiduciary duties to the company or to other shareholders, and may therefore vote in their own self interests and, on the other hand, that the principle may enable the majority to oppress the minority in a way in which many would regard as unacceptable.

6 Subject to the comments below regarding class rights.

This non-committal attitude is perhaps understandable on the facts of *Gambotto*. The resolution was held to be invalid on other grounds. Further, it was passed unanimously on a poll at which only the three minority shareholders who attended the meeting voted. Interestingly, Mr Gambotto was not one of these three shareholders. However, it was potentially a very real issue in the case, since Mr Gambotto owned 51% of the remaining shares, and thus had sufficient voting power to block a special resolution on a poll, if the majority shareholders did not vote.

Although the High Court did not decide this issue, there have been developments in related areas which may give some clue as to the likely attitude to be adopted if this were an issue in a future case.

Ratification of directors' breach of duty and related party transactions

Law reform proposals[7] on ratification and release of directors from liability to the company (including the proposal for a statutory derivative action[8]) uniformly recommend that interested directors, their associates and relatives should not be able to vote as shareholders on the resolution.

This philosophy has been implemented in Part 3.2A of the Corporations Law which deals with related party transactions by public companies and their "child entities", and allows non-arm's length financial benefits to be given to related parties (such as company directors) if they are approved at a general meeting at which neither the related party nor any associate votes (unless the ASC permits them to vote).[9]

The same approach can also be seen in various listing rules. For example, independent shareholder approval is required:

- under Listing Rule 3J(3) for certain transactions between listed companies and their directors, substantial shareholders or other associated persons; and
- under Listing Rule 3E(8) for participation by directors or their associates in certain issues of securities.

Schemes of arrangement

In the context of conflicts between majority and minority shareholders, there is also a longstanding legislative example of the same philosophy in the statutory provisions relating to schemes of arrangement. In this context members are divided into classes on the basis of the effect of the scheme on their rights.[10] Approval for the scheme must

7 See Companies and Securities Law Review Committee, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No 10, May 1990, recommendation 60 and House of Representatives Standing Committee on Legal and Constitutional Affairs (Lavarch Committee) *Corporate Practices and the Rights of Shareholders*, AGPS, November 1991, recommendations 23 and 24.

8 Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action*, July 1993 at 21; Bill Relating to Proceedings on Behalf of a Company (Statutory Derivative Action), Exposure Draft, September 1995.

9 Section 243ZF, Corporations Law.

10 *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 at 583.

be obtained from the requisite majority (75% in value and 50% in number) of each class of members. Further, the court may discount, or discard the votes of a member of the class who has interests opposed to those of the class as a whole.[11] Class rights are, however, not confined in their operation to schemes of arrangement.

Class rights

One point which is easily overlooked when discussing older cases concerning alterations to articles, such as the two leading cases (prior to *Gambotto*'s case) of *Allen v Gold Reefs of West Africa Ltd*[12] and *Peters' American Delicacy Co Ltd v Heath*[13] is that they have been overtaken by the modern interpretation of the legislative protection given to class rights

In *Allen's* case, the alteration to the articles gave the company a lien on fully paid shares to cover debts owed to it by the only shareholder who held such shares, Mr Zinotty. Prior to the amendment, the articles give the company such a lien only on partly-paid shares. As mentioned above, in the *Peters' American Delicacy* case, the alteration to the articles changed the basis for distribution of profits to partly-paid shareholders.

Thus, both cases concerned adjustments of rights as between fully and partly paid shareholders. Support for the view that partly-paid shares may be regarded as being in a different class from fully-paid shares can be found in the definition of "class" in the ASX Listing Rules and in the case of *Re Campaign Holdings Pty Ltd*.[14] On this basis, and in light of the interpretation given to the legislative class rights protections in more recent cases, the minority shareholders in *Allen's* case and *Peters'* case would have had a right of veto over the alterations. However, clearly not all alterations to company articles will raise questions of class rights.[15]

Reductions of capital

Decisions in the context of reductions of capital perhaps give the best guide as to the likely approach of the courts to voting by interested shareholders. In *Nicron Resources Ltd v Catto*[16] Bryan J considered it to be "common prudence" that majority shareholders who stood to benefit from a reduction of capital refrain from voting, since otherwise it would be difficult to persuade the court that the result was fair. This approach was taken a step further in another reduction of capital case, *Re Shine Fisheries Ltd*[17] where Master Adams said:

11 *Re Jax Marine Pty Ltd* [1967] 1 NSWR 145.

12 [1900] 1 Ch 656.

13 (1939) 61 CLR 457.

14 (1989) 15 ACLR 762; 8 ACLC 64.

15 Note that there are other legislative provisions which require independent shareholder approval for certain transactions: see section 206E, Corporations Law.

16 (1992) 8 ACSR 219; 10 ACLC 1,186.

17 (1994) 12 ACSR 627; 12 ACLC 223.

> The principle of fairness requires that only those shareholders whose shares are to be cancelled should be entitled to vote at the meeting and that any parties related to the [majority shareholders] or associated in any way with them should not vote. This seems to me to be a fundamental aspect of fairness as otherwise those who stand to benefit from the transaction could overwhelmingly carry the resolution by virtue of their majority holding

In light of the fact that there is no necessary involvement of the court in a resolution to alter articles of association,[18] there is an even stronger argument for requiring the resolution to be passed by an independent majority of shareholders in that context where the interested majority shareholders stand to benefit from it.

Common Law and Statutory Remedies

A final issue in the case is the interrelationship between common law and statutory remedies available to minority shareholders. At all three levels of decision, *Gambotto* was decided on purely common law grounds. There was some uncertainty as to exactly what the common law test entailed, but in none of the judgments was there discussion of whether the resolution could have been challenged under section 260 of the Corporations Law (which provides a remedy for minority shareholders in respect of conduct which is oppressive, unfairly prejudicial, unfairly discriminatory or contrary to the interests of the members as a whole).

It is interesting to contrast *Gambotto* with an earlier case concerning the validity of an alteration to company articles of association, *Shears v Phosphate Co-operative Company of Australia Ltd*.[19] This case arose out of Mr Shears' attempt to circumvent the maximum shareholding and voting restrictions in the company's articles by entering into contracts to purchase shares under which he was appointed attorney to attend and vote at meetings on the shareholders' behalf pending registration of the transfer. The company countered this stratagem with an alteration to the articles under which a person was deemed to hold a share if he or she had a "relevant interest" in the share (within the statutory definition of that term) and empowered the directors to require a shareholder to provide the company with satisfactory evidence that no other person had a relevant interest in his or her shares, in the absence of which, the shareholder was not entitled to vote in respect of the shares.

The alteration was held to be invalid on both common law and statutory grounds and the court distinguished the test to be applied under the two remedies. At common law, the court applied the "bona fide for the benefit of the company" test which, at least nominally, focused on the subjective beliefs of the shareholders as to the effect of the resolution on the company and in this context regarded the new article as administratively unworkable. Under the statutory remedy, the court's focus was on the effect of the resolution on the plaintiff and it held that the alteration was oppressive on the basis that

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18 As the law currently stands, court confirmation is required for a reduction of capital.

19 (1988) 14 ACLR 747; 7 ACLC 812.

the new article diluted the plaintiff's voting power relative to those opposed to him.

Admittedly, the bona fide for the benefit of the company test was applied objectively in *Shears'* case, in the sense that the decision was set aside by analogy with the decision of a jury on the basis that no reasonable person could have thought it was for the benefit of the company. Nevertheless, a distinction was drawn between the two tests, the common law test having as its emphasis the subjective belief of the shareholders as to the company's best interests, and the statutory remedy being concerned with the objective reasonableness of the effect of the resolution on the plaintiff, in light of the history and nature of the company.

The replacement by the High Court in *Gambotto* of an essentially subjective common law test, with a test which focuses on whether the alteration is oppressive or beyond any purpose contemplated by the articles blurs this distinction. The move towards assimilation of the tests makes it perhaps even more surprising that the statutory remedy was not discussed.

Part 3

Theoretical Implications of Gambotto

Chapter 7

Proprietary Norms in Corporate Law: An Essay on Reading Gambotto in the United States

Deborah A DeMott[1]

It is a truism that national economies are extensively linked in the late twentieth century. Capital markets, in particular, transcend national boundaries; among developed economies, funds for investment move quickly and in vast amounts. One might be tempted as a result to anticipate an inevitable convergence among nations of the legal norms that underly capital investment. Corporate law, in particular, seems a likely candidate for convergence because it defines the corporate enterprise and the relationship between investors and managers. It also specifies the legal protection accorded to investors' expectations. Convergence in the corporate law context is a natural-feeling thesis for proponents of a Hegelian thesis of historical evolution,[2] as well as for the efficiency-oriented proponents of the economic analysis of legal rules and institutions.[3]

The High Court's opinion in *Gambotto v WCP Ltd*[4] is a development that confounds robust visions of impending convergence among corporate law regimes. By treating a shareholder's interest as proprietary, the *Gambotto* court impeded transactions that eliminate the equity investment of minority shareholders. By comparison, corporate law in the United States, and particularly in Delaware, facilitates such transactions, commonly (and not always pejoratively) known as "freezeouts." Additionally, in the United States, a freezeout transaction would utilize substantially different statutory mechanisms, and litigation challenging the transaction would be structured differently from the *Gambotto* litigation.

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1 Professor of Law, Duke University.

2 See eg, Francis Fukuyama, *The End of History and the Last Man* (1992) (convergence thesis of evolution in political structures toward liberal democracy).

3 The standard account is one of competition among states for corporate charters, focusing on statutes. See Roberta Romano, *The Genius of American Corporate Law* (1993). In the United States, Delaware dominates as the situs of incorporation for public companies. Although they differ in some respects, state corporation statutes are relatively uniform. Other states mimic Delaware, and it adopts innovations introduced elsewhere to maintain its lead. See generally Michael Klausner, "Corporations, Corporate Laws and Networks of Contracts" (1995) 81 *Virginia L Rev* 757 n 283.

4 (1995) 182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243.

Reading *Gambotto* is a startling experience for a United States lawyer, not because the case illustrates differences in formal statutory mechanics, but because the normative bases for the majority judgment diverge dramatically from assumptions prevailing in the United States. Additionally, United States lawyers would be startled by the fact that Mr Gambotto represented himself in the lawsuit and by his resilience as a pro se litigant, given the duration of the lawsuit and the relatively small value of his investment. In this chapter I describe initially how a *Gambotto*-like transaction would as a formal matter be structured under United States corporation statutes and how challenges to the transaction would proceed. I then examine the larger comparative interest of the case: it illustrates the profound significance to practical outcomes of underlying assumptions about the nature of corporate law structures and equity investment. In United States corporate law, property-based ideas do not have as dominant a place in defining the nature of shareholding as the High Court accords them in *Gambotto*.

Statutory Mechanisms to Eliminate Minority Shareholders

The dispute in Gambotto

Industrial Equity Limited ("IEL") owned 99.7% of the issued shares of WCP Ltd, all but 50,590 of WCP's shares. IEL determined that eliminating the minority shareholding in WCP would be a tax-efficient move. It anticipated selling WCP's land holdings at a gain, then offsetting the taxes due with otherwise unusable tax losses realized elsewhere in the IEL group of companies. IEL was unable to eliminate WCP's minority shareholders through statutory provisions that explicitly permit compulsory acquisition of minority shares by a majority shareholder, due to the provisions' high approval thresholds;[5] the provisions require the acquisition to be approved by 90% in nominal value and 75% in number of minority shares. The dissentient shareholders in *Gambotto* held 15,898 shares out of the 50,590 not held by IEL. To eliminate the minority thus required either a voluntary sale of the dissentients' shares or an alternate statutory mechanism with less onerous voting requirements to compel the disposition of all minority shares. The alternate mechanism of choice was an amendment to WCP's articles.

The amendment proposed by WCP's directors would have conferred on a shareholder entitled to 90% or more of WCP's shares, the right to acquire compulsorily all of WCP's issued shares at a price of $1.80 per share. Under the Corporations Law, altering or amending articles requires a special resolution adopted at a shareholder meeting.[6] The vote required is a majority vote based on a quorum of at least 75% of shareholders entitled to vote.[7] Prior to the shareholder meeting, WCP shareholders received an expert's report valuing the shares at $1.365, a valuation the dissentient shareholders conceded to be independent and fair. All shareholders present at the

5 Corporations Law ss 414(5)(b) and 701(3)(c)(ii).
6 Ibid s 176(1).
7 Ibid s 253(1)(b).

meeting voted in favor of the amendment (the dissentients did not appear personally or by proxy). The dissentient shareholders challenged the amendment as oppressive and beyond the statutory power to amend articles. A majority of the High Court agreed, reversing the New South Wales Court of Appeal.[8]

The High Court majority held that the power to amend a corporation's articles could be used to eliminate a shareholder only when that shareholder's continuing ownership would be detrimental to the corporation. The opinion gives two specific examples of detriment. A freezeout would be justifiable when a shareholder competes with the corporation or when necessary for the corporation's continuing compliance with a regulatory requirement applicable to its principal business that, for example, concerns shareholders' nationality. In contrast, the majority explicitly disapproved of freezeouts that would enable the corporation to pursue a new commercial advantage. The majority reasoned that the proprietary nature of shareholding is inconsistent with any less onerous standard for expropriation, and allocated the burden of establishing validity to the majority shareholder. Additionally, reasoned the majority opinion, to permit the use of amendments to articles to eliminate minority shareholders would circumvent "the protection which the Corporations Law gives to minorities who resist compromises, amalgamations and reconstructions, schemes of arrangement and takeover offers."[9]

Justice McHugh's separate opinion, like the majority opinion, assigns to the majority shareholder the burden of establishing that the amendment was not oppressive. The relevant standard, however, should be whether the freezeout "will enable the company to pursue some significant goal, or to protect itself from some action that is external to the company."[10] This standard is broader than that adopted by the majority opinion because it would permit a freezeout that enables the corporation to pursue an opportunity otherwise foreclosed to it. Justice McHugh's opinion expressly approves as a legitimate business objective the realization of significant tax savings. But, the opinion concludes, proponents of the WCP transaction failed to prove that it was not oppressive, that is, that the price was fair, the minority shareholders were dealt with fairly and "a full disclosure of all matters in relation to the alteration and expropriation has been made."[11]

Freezeouts in the United States

A transaction like that attempted in *Gambotto* would usually be structured as a merger in the United States. Following a resolution from the subsidiary corporation's directors, the majority shareholder would vote its shares to merge the corporation with another corporation, most likely an existing wholly-owned subsidiary of the majority

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8 *WCP Ltd v Gambotto* [1993] 30 NSWLR 385.

9 (1995) 182 CLR 432 at 446.

10 Ibid at 455.

11 Ibid at 459.

shareholder or a new subsidiary created solely for use in the merger.[12] The resolution would specify the consideration to be received by minority shareholders in exchange for their shares. If the majority shareholder holds a very large proportion of the stock - 90% under the Delaware statute and the Revised Model Business Corporation Act - the directors' adoption of a plan of merger suffices and it is not necessary to obtain a shareholder vote on the merger.[13] Shareholders who dissent from the transaction have the right, following a judicial appraisal proceeding, to receive in cash the value of their shares as of the time of the merger.[14]

Corporation statutes in the United States do not contain counterparts to the statutory oppression remedy.[15] A shareholder challenging the propriety of a freezeout would, instead, argue that the transaction breached the majority shareholder's fiduciary duty to the minority.[16] The general proposition that a majority shareholder should be treated as a fiduciary toward the minority is long- and well-established in US caselaw. This principle is not understood to make it improper for the majority to exercise its voting power. Cases applying the principle to the specific context of freezeout mergers fall into two groups. First, since 1983, the Delaware standard has been that the majority must establish the "entire fairness" of the transaction by establishing fair price and fair dealing; Delaware caselaw does not require any showing as to the purpose of the transaction.[17] Second, courts in several other states - like Justice McHugh's opinion in *Gambotto* - additionally require a showing that the transaction had a bona fide business purpose.[18] Delaware

12 See eg, Del Code Ann, tit 8, s 251; Rev Model Business Corp Act ss 11.01 and 11.03. Under these statutes, a simple majority of outstanding shares suffices to approve a merger, in the absence of complications created by division of shareholders into distinct classes or voting groups. A statutory share exchange is an alternate structure under the Revised Model Business Corporation Act. See ibid s 11.02. Merger and share exchange statutes do not require that the transaction be approved by a majority of minority shareholders.

13 See Del Code Ann, tit 8, s 253; Rev Model Business Corporation Act s 11.04.

14 See Del Code Ann, tit 8, s 262, Rev Model Business Corporation Act ss 13.01-13.03; 13.20-13.28; 13.30-13.31.

15 The closest comparison is with statutory provisions that treat oppression as a basis for involuntary dissolution in a petition brought by a shareholder. See eg, RMBCA s 14.30(2)(ii). In about half of the states, a buyout of the complainant's holdings is an alternative remedy. Some states limit the buyout remedy to closely-held corporations. See F Hodge O'Neal and Robert B Thompson, *O'Neal's Oppression of Minority Shareholders*, ss 7.13 and 7.19 (2d ed, 1991).

16 In some states, appraisal is by statute the shareholder's sole and exclusive remedy following a merger. These statutory provisions vary, and some (but not all) courts have recognized exceptions for outright fraud. See Victor Brudney and William W Bratton, *Brudney and Chirelstein's Corporate Finance* 797-98 (4th ed, 1993).

17 *Weinberger v UOP, Inc* 457 A 2d 701 (Del 1983).

18 See *Perl v UI Int'l Corp*, 607 P 2d 1036, 1046 (Hawaii 1980) (merger effected for sole purpose of freezing out minority is breach of majority shareholder's fiduciary duty); *Coggins v New England Patriots Football Club, Inc*, 397 Mass 527, 492 NE 2d 1112 (1986) (controlling shareholder has burden of showing that freeze-out furthered a business purpose); *Berkowitz v Power/Mate Corp*, 135 NJ Super 36, 342 A 2d 566 (1975) (enjoining transaction when majority shareholder did not establish business purpose for transaction or fairness of price to minority); *Alpert v 28 Williams Street Corp*, 63 NY 2d 557, 473 NE 2d 19 (1984) (in freeze-out merger, removal of minority will be justified when related to advancement of a general corporate interest).

cases required a showing of business purpose from 1977[19] through *Weinberger v UOP, Inc*, decided in 1983. The *Weinberger* court jettisoned the business purpose requirement on the basis that it provided no additional meaningful protection to minority shareholders, given the entire fairness test, the operation of the appraisal remedy, and the court's "broad discretion...to fashion such relief as the facts of a given case may dictate..."[20]

Delaware cases apply the entire fairness test to directors' decisions that are not protected by the business judgment rule from judicial scrutiny of the merits of the decision. The business judgment rule would, for example, be inapplicable to a decision made by self-interested directors[21] or to a decision made by directors who were insufficiently informed prior to making the decision.[22] *Weinberger* applied the test to a cashout merger because the directors of the subsidiary corporation were dual (and conflicted) fiduciaries, who owed fiduciary duties to the minority shareholders as well as the majority.[23] The operative content of entire fairness varies somewhat with the type of transaction at issue. If, for example, a parent corporation has benefitted at the expense of the subsidiary in dealings between them, the entire fairness standard requires the parent to disgorge the benefit.[24]

As detailed in *Weinberger*, in the freezeout context the standard encompasses separate but ultimately related aspects of fair dealing and fair price. An inquiry into fair dealing implicates questions about the timing, structuring, negotiation and disclosure of the transaction. Fair price under *Weinberger* includes all "elements that affect the intrinsic or inherent value of a company's stock" and is equivalent to the general appraisal remedy.[25] Although *Weinberger* and its progeny do not dictate any particular definition for "intrinsic or inherent value" that would specify a division of anticipated gains between majority and minority shareholders, *Weinberger* permits introduction of evidence of elements of future value known or susceptible of proof as of the date of the merger.[26]

Although the differences among US jurisdictions are significant, their magnitude seems puny once one reads the majority opinion in *Gambotto*. The *Gambotto* majority explicitly imposed a substantive hurdle for freezeouts that differs from the business purpose test and ranges well beyond the entire fairness standard in *Weinberger*. Additionally, the potential reach of the reasoning in *Gambotto* is open to question in several respects, some of them interrelated. The principle adopted by the majority in *Gambotto* is, on its face, broadly applicable and would reach actions that are not

19 See *Singer v Magnavox Co*, 380 A 2d 969 (Del 1977).

20 457 A 2d 701 at 715.

21 See eg, *Gottlieb v Heyden Chemical Corp*, 91 A 2d 57, 57-58 (Del 1952).

22 See eg, *Smith v Van Gorkom*, 488 A 2d 858, 893 (Del 1985).

23 457 A 2d at 710. *Weinberger* contains a dictum strongly encouraging the use of an independent committee comprised of the subsidiary's outside directors; the use of such a committee is "strong evidence that the transaction meets the test of fairness." Ibid at 709 n 7. See also *Gambotto* at 446 (leaving open whether majority must refrain from voting).

24 See eg, *Sinclair Oil Corp v Levien*, 280 A 2d 717, 720 (Del 1971).

25 457 A 2d at 710.

26 Ibid at 713.

preliminary to expropriations of minority interests. *Gambotto* emphasizes the "proprietary nature" of a share, characterising a share as more than a capitalized stream of dividends. *Gambotto* would thus be implicated by an unconsented-to alteration of any non-economic prerogative conferred by the share that can be characterized as a proprietary right. Alteration to voting rights would be an obvious example. It is an open question, to say the least, whether *Gambotto* applies to alterations that treat all shares equally, or whether the case should be read as applicable only to transactions that are uniquely advantageous to the majority shareholder.

On the freezeout front, a pressing question is *Gambotto's* applicability to freezeout transactions effected other than through an amendment to articles. The Corporations Law contains provisions permitting binding compromises or arrangements between a corporation and its members, subject to approval from 75% of the nominal value of the shares present and voting and to judicial approval.[27] The court may condition its approval on "such alterations or conditions as it thinks just."[28] As it happens, the leading Australian treatise suggests that this statutory mechanism could be used to effect a "conversion of preference shares to debentures,"[29] that is, to compel an exchange of equity securities for debt. The *Gambotto* majority does not fully address the circumstances under which a minority shareholder may be bound by a compromise or arrangement that eliminates the shareholder's equity investment. A passage in the opinion quoted earlier notes the statutory protection afforded minorities who resist schemes of arrangement (and other transactions). One might read this passage to exempt schemes from the operation of the *Gambotto* principle, on the basis that the protective statutory structure supersedes the consequences of the shares' proprietary nature. But the statutory standard for judicial approval of a scheme is whether it is "just", and it would be unsurprising were *Gambotto* to frame or influence operative conceptions of justice.

Relatedly, the *Gambotto* majority disapproves of the use of the alteration of articles mechanism to circumvent the protective features of other mechanisms in the statute. Interdependence of statutory provisions is the unarticulated premise supporting this point. It is not evident how broad a doctrine of interdependence the majority have adopted. Alternatively, a court could accord independent operation or equal dignity to each formally distinct mechanism created by the same statute.[30] As it happens, US courts disagree on this question. Delaware and states following its lead usually apply an equal dignity doctrine, permitting (for example) the elimination of accrued dividends on preferred stock through a merger although the statute prohibits achieving the same

27 Corporations Law s 411(4)(a)(ii).

28 Ibid s 411(6).

29 See H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (1995) para 24.010.

30 As did Meagher, J A, writing for the Court of Appeal in *Gambotto*. See [1993] 30 NSWLR at 389 (various provisions in Corporations Law do not "constitute some sort of code governing the expropriation of shares").

end through an amendment to the corporation's charter.[31] Courts in other states have, at least in specific contexts, rejected the equal dignity doctrine; the best-known case, *Faris v Glen Alden Corp* recharacterizes as a merger a transaction formally structured as a purchase of assets, and thereby confers voting and appraisal rights on the shareholders of the purchaser.[32] While some degree of tension between form and substance in corporate law is inevitable,[33] the majority opinion in *Gambotto* is striking because it resolves the tension through a potentially unbounded, albeit unarticulated, anti-formalist stance.

Australian commentators on the practical effect of *Gambotto* predict an increase in greenmail transactions, that is, in individually-negotiated transactions in minority shares at prices or on terms not available to other minority shareholders.[34] In general, majority shareholders may find it attractive to acquire the minority's shares through voluntary transactions that do not implicate the sundry statutory mechanisms, varying the purchase price when necessary.

Australian corporations could in theory foreclose greenmail threats by adopting articles amendments that prohibit the payment of greenmail, as did many US corporations in the 1980's. Suppose, however that a shareholder dissents from the amendment and argues that, if effective, the amendment would constitute oppression under the reasoning in *Gambotto*. The dissentient shareholder would, as a result of the amendment, lose the ability to obtain an individually-negotiated sale of his shares, an arguably proprietary feature of share ownership. One response would be that an anti-greenmail amendment satisfies the criteria for legitimacy specified in *Gambotto*. Foreclosing an avenue to extract greenmail forecloses a prospective detriment, in this instance not a detriment to the corporation's current commercial operation, but to the nongreenmailers among minority shareholders. The theory of detriment is that each dollar extra paid to the greenmailer is a dollar less available to pay to all other minority shareholders. On the other hand, if the shares in question are viewed solely as the dissentient shareholder's individual property, demanding a higher price for them does not seem inappropriate. Moreover, *Gambotto* may require a more immediate detriment than this example suggests.

Gambotto's reasoning suggests an analogy to real estate development. A real estate developer may offer to buy a group of adjoining parcels for the same price per acre. It is not unusual, nor is it morally or legally objectionable, for any individual owner to hold out for a higher price. If the developer pays the higher price, moreover, it does

31 See *Federal United Corp v Havender*, 11 A 2d 331 (Del Ch 1940); *Bove v Community Hotel Corp*, 105 RI 36, 249 A 2d 89 (1969).

32 143 A 2d 25 (Pa 1958).

33 Indeed, Delaware cases overall are not consistent. Some recharacterize transactions on the basis of economic substance while others decline to do so. See generally Ronald J Gilson and Bernard S Black, *The Law and Finance of Corporate Acquisitions* (2d ed, 1995) at 682.

34 See Saul Fridman, "*Gambotto v WCP*: No Definitive Statement on Issue" *Australian Financial Review*, March 13, 1995.

not necessarily pay a lower price to all other property owners. The developer may simply be spending a larger amount on land acquisition which, other things being equal, would make the project less profitable for the developer. It remains to be seen whether *Gambotto* implies a comparably atomistic view of members' proprietary interests. By characterizing the dissentients' shareholding as a proprietary interest, the *Gambotto* majority pretermitted any reason to consider the legitimacy of any particular shareholder's reasons for refusing to sell at a given price. To the extent the real estate analogy underlies *Gambotto's* reasoning, the principle in the case applies regardless of whether the proposed transaction treats all members equally.

Proprietary Norms

Gambotto demonstrates the power of theory in corporate law disputes: as the case illustrates, how we think about the nature of shareholding has major practical consequences. The preceding comparison with US corporate law might prompt the conclusion that its treatment of shareholders is free of intellectual artifacts derived from property. To be sure, members' rights to remain as such are, as we have seen, readily defeasible in the United States under standards much less exacting than those adopted by the majority in *Gambotto*. All the same, notable features of the US corporate law landscape are explicable only by reference to concepts derived from property norms.

In characterizing the forms of legally-protected entitlements, legal theorists conventionally distinguish between property rules and liability rules.[35] For our immediate purposes, the key difference is that under a property rule the holder of an entitlement has a veto over any proposed transfer of the entitlement, whereas under a liability rule a nonentitled party may purchase the entitlement at a price set by a court. This abstract distinction applies neatly to the treatment of freezeout transactions in Delaware law contrasted with *Gambotto*. Delaware applies a liability rule to freezeouts. Subject to establishing that the transaction was entirely fair to the minority if it is challenged by a shareholder, the majority has the right to compel the minority to sell at a price set by directors elected by the majority, the price in turn always open to judicial scrutiny through the appraisal remedy.[36] *Gambotto*, in contrast, applies a property rule, subject to one modification: each shareholder has an absolute veto over the sale of his shares, unless the majority establishes his continuing ownership itself to be detrimental.

Aspects of corporate law resist complete capture by this simple dichotomy, however. Consider the implications of the court's authority under *Weinberger* to fashion such relief as the facts of a given case dictate, when a controlling shareholder has not acted with entire fairness. *Weinberger* explicitly permits the court to award rescissory damages,

35 See Guido Calabresi and A Douglas Melamed, "Property Rules, Liability Rules and Inalienability: One View of the Cathedral" (1972) 85 *Harv L Rev* 1089.

36 Appraisal provisions in US corporation statutes are far from uniform in applicability and operation. For a comprehensive evaluation, see Hideki Kanda and Saul Levmore, "The Appraisal Remedy and the Goals of Corporate Law" (1985) 32 *UCLA L Rev* 429.

noting that the appraisal remedy - which gives the shareholder the fair value of his shares as of the time of the merger - may be inadequate in circumstances including "fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching..."[37] Rescissory damages are, in monetary form, a proprietary remedy, a substitute for return of property in kind. In the absence of some proprietary element in shareholding, the robust presence of this remedy in shareholder litigation would be difficult to explain. Even if the remedy is characterized as an unusual form of liability rule, its justification derives from a property-based conception of the initial entitlement. Nor is the presence of rescissory relief adequately explained by the objective of deterring specified forms of conduct. Punitive or exemplary damages more directly serve a deterrent function, yet are distinct from rescissory damages.

The proprietary character of some aspects of corporate law is likewise evident in the Delaware Supreme Court's most controversial recent case, *Cede & Co v Technicolor, Inc.*[38] In *Cede*, the court held that proof of injury was not an element of a shareholder's cause of action for directors' breach of their duty of care.[39] Technicolor's directors approved an arms-length merger of the corporation without conducting an auction or structuring an effective post-agreement market check to legitimate the negotiated price. The directors' decision to approve the merger fell outside the protection of the business judgment rule because it was not adequately informed. As a consequence, the directors had the burden of establishing the entire fairness of the merger. In an appraisal action tried first by the Court of Chancery, the court determined that the merger price was fair. The supreme court reversed the lower court's reliance on a "no harm, no foul principle"; the supreme court also emphasized that under the entire fairness standard applicable to the dispute - the plaintiff having rebutted the presumptions of the business judgment rule - ultimate recovery would not be limited to the difference between the merger price and value as determined by appraisal because it might well include elements of rescissory damages.

The outcome in *Cede* is baffling if the shareholder's entitlement to duly informed service from directors is treated exclusively as a form of liability rule, one that resembles entitlements created by tort law. The directors' breach deprived the shareholders of that entitlement, but through the resulting merger the shareholders received a price at least equal to the appraised value of their stock, as determined by a court. If the shareholders' entitlement is, in contrast, treated as a form of property rule, the merger is the consequence of an unconsented-to transfer or taking, and the shareholders are presumptively entitled to the return of their shares. Translated into monetary relief, shareholders should receive an amount equal to the current value of the shares, an

37 457 A 2d at 714 (1983).

38 634 A 2d 345 (Del 1993). The purchaser in *Cede* sold Technicolor six years after the merger for $750 million, having paid $125 million through the merger. The plaintiff in *Cede* sought to recover $40 million. The suit named as defendants Technicolor's directors at the time of the merger, plus the purchaser and its controlling shareholder. See generally Karen Donovan, "Delaware Court Hears Takeover Case Third Time", *National Law Journal*, June 5, 1995, at B1.

39 Ibid at 371.

entitlement that gives shareholders the benefit of post-merger appreciation in value.

The availability to shareholders of a proprietary remedy is, nonetheless, significantly different from the form of shareholders' entitlement under *Gambotto*. Rescissory damages become available under *Weinberger* only when the majority has acted wrongfully. If the majority deals fairly, although the appraisal remedy may result in dissenting shareholders receiving more than the merger price, the majority shareholder has no general duty to account for benefit it realizes through the freezeout. Indeed, in its latest opinion in the *Cede* litigation, the Delaware Supreme Court affirmed the Court of Chancery's determination on remand that the transaction was entirely fair to Technicolor's shareholders.[40] The Supreme Court emphasized that liability is not automatic under the entire fairness standard; analysis under the standard requires the trial court to examine and balance "the nature of the duty or duties the board breached vis-a-vis the manner in which the board properly discharged its other fiduciary duties."[41] In contrast, under *Gambotto*, each minority shareholder has an absolute veto over the sale of his shares. The presumptive value to any or all minority shareholders of their veto power is the gain the majority shareholder anticipates through the freezeout. On the *Gambotto* facts, the benchmark amount would be the value of the projected tax savings. Generalised, the legal principle in *Gambotto* is distributively more favorable to minority shareholders than the *Weinberger* approach.[42]

Distributional consequences are not the end of the story, however. The history of corporate law in the United States illustrates that legal rules have consequences for business efficiency. Two points in the evolutionary line are salient. Well into the nineteenth century in the United States, any fundamental corporate change required shareholders' unanimous consent; any shareholder could block the corporation's consolidation with another corporation, and could also block a major purchase or sale of assets.[43] As the century progressed, "[i]t became increasingly apparent to observers that great benefits to society, to the corporation, and derivatively to the rest of the shareholders were sometimes blocked to protect interests that seemed quite minor or even venal to the remaining shareholders and perhaps to most outsiders."[44] This era led

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40 *Cinerama, Inc v Technicolor, Inc.*, 1995 WL 431434 (Del, July 17, 1995).

41 Ibid. The Supreme Court's opinion does not specify respective weights to be assigned in the balance, nor does it articulate categorical restrictions on the availability of rescissory damages. The Court of Chancery's opinion, in dicta, observes that rescissory damages may be an appropriate remedy against a director when the director has breached the fiduciary duty of loyalty but that such damages should never be awarded when the director has breached only the duty of care. The underlying principle limits the availability of rescission or a substitute for it to one who participates in a transaction as a principal or as a co-conspirator of a principal or "has a material conflict of interest of another sort." See *Cinerama, Inc v Technicolor, Inc*, 1994 WL 568654 (Del Ch, October 6, 1994).

42 Entitlement forms that give the in-kind holder more control over transfer are, in general, more distributively favorable to in-kind holders than are liability rules. See Madeline Morris, "The Structure of Entitlements" (1993) 78 *Cornell L Rev* 822 at 854.

43 See William J Carney, "Fundamental Corporate Changes, Minority Shareholders, and Business Purposes" [1980] *Am Bar Found Res J* 69 at 80.

44 Ibid at 81

to general corporation legislation that facilitated mergers by majority shareholder vote and created appraisal rights. Merger legislation itself evolved significantly in the twentieth century, with changes that permitted the distribution to shareholders of consideration other than shares of the surviving corporation, and, in particular, the distribution of cash.[45] Courts in turn legitimated the use of these statutes to eliminate minority shareholders.[46] Later cases like *Weinberger* regulate freezeout tactics. This history, from its start to present, encapsulates a shift from a property rule to a liability rule, driven (if one credits the historians) by legislative and judicial concern for business efficiency.

Conclusion

Many factors might help explain the relative primacy that *Gambotto* accords to a proprietary conception of shareholding. For starters, in the Australian context, arguments grounded in efficiency concerns may be less compelling, as applied to freezeouts, than in the United States. The Australian universe of public companies and securities trading is much smaller than its counterpart in the United States. Justice McHugh's opinion in *Gambotto* notes that price volatility in the Australian market is noticeable and not necessarily the product of rationally explicable factors.[47] As a result, observers of the Australian market, and of corporate transactions more generally, may perceive a disjunction between activity dominated by securities markets and underlying business enterprise. Freezeouts, moreover, often follow in the wake of takeovers and other larger transactions in corporate control; freezeouts' social utility may be in question in an environment skeptical about the broader social value of stock markets and takeover activity.

Relatedly, Australians who make direct investments in domestic equities have many fewer choices than do their counterparts in the United States.[48] After a freezeout, opportunities to reinvest, at least in domestic equities, are more limited in Australia. A shareholder's identity as a member of a company, not merely as a provider of equity investment, is likely stronger in a world that appears to afford fewer investment choices. This appearance is a bit illusory, however, if nondomestic equity investments, or pooled

45 See Gilson and Black, supra n 33 at 1253-54.

46 See eg, *Stauffer v Standard Brands, Inc*, 187 A 2d 78 (Del Ch 1962).

47 (1995) 182 CLR 432 at 458. Debates over the significance of volatility in US securities markets focus on whether volatility increased in the 1980's, when the transactions costs of trading became lower. Volatility statistics for the 1980's look very different depending on one's treatment of the October 1987 crash. After the 1987 crash, volatility returned to pre-1975 levels. See Paul G Mahoney, "Is There a Cure for 'Excessive' Trading" (1995) 81 *Virginia L Rev* 713 at 730-31. Average volatility data for the Australian stock market illustrate that it is the least volatile market in the Asia-Pacific region. See Australian Stock Exchange, *Market Report 1994* at 12.

48 The US securities market is enormous. The New York Stock Exchange - listing venue for most large US corporations - in 1994 listed 2,510 companies, including 204 non-US listings. New York Stock Exchange, *Fact Book for the Year 1994*, at 8. Total US equities outstanding had an estimated value of US$6.1351 trillion in the third quarter of 1994. Ibid at 83. As of June 1994, total capitalization on the Australian market was A$287.6 billion. See Australian Stock Exchange, *Market Report* 1994 at 11.

investment vehicles, are readily available choices.

A further explanation may lie in differences between the structure and approach of corporate law in the two countries. The formal qualities of corporate law in Australia are markedly different from corporate legislation in the United States. The Corporations Law does not include provisions that authorize merger transactions and, as *Gambotto* notes, the statutory treatment of compulsory acquisitions requires a high degree of assent from the minority. On several points, the Corporations Law is more complex and contains much more mandatory prescription than counterpart legislation in the United States.[49] In contrast, requirements for extensive periodic disclosure of information have long been a feature of federal securities regulation in the United States but are relatively recent in Australia. An information-rich environment may engender greater confidence in the integrity of corporate decisionmakers because greater visibility legitimates their decisions.[50] In contrast, in a legal universe where so much is specified by statute in great detail, the omitted - like freezeouts - may presumptively be prohibited.

Comparative law scholarship is ill-suited to prescriptive conclusions. We do well to understand the differences between legal norms in different systems and do very well indeed if we can explain their origins. It is no criticism of the majority's approach in *Gambotto* that it differs profoundly in many respects from norms of corporate law that prevail in the United States. The question warranting further inquiry is the fit between *Gambotto* and the objectives and presuppositions of corporate law in Australia.

49 Examples include the statutory treatment of share repurchases and takeover bids.

50 Freezeouts are subject to specific disclosure requirements under federal securities regulation when they have the effect of eliminating public shareholders in a public company. The relevant SEC rule does not regulate the purpose or pricing of the transaction. It does, however, require the company's directors to state whether they believe the transaction to be fair or unfair to minority shareholders and to discuss the factors on which such belief is based. SEC Rule 13e-3, Schedule 13E-3, item 8. Counterpart regulation in Canada, issued by the Ontario Securities Commission, imposes substantive requirements for minority approval and valuation. See Ontario Securities Commission, Policy Statement 9.1. Further discussion of the regulation of freezeouts in Canada is contained in Chapter 9.

Chapter 8

An Economic Analysis of Gambotto

Michael J Whincop[1]

The decision of the High Court in *Gambotto v WCP Ltd*[2] has significant practical implications for corporations and their lawyers. The decision itself may herald a substantial change in the manner of judicial resolution of questions and conflicts that arise between the members of a company. One could hardly rule out the notion that the case may be a harbinger of the emergence of an approach that finds implied rights in corporate constitutions in the same way that the High Court has managed to find them in the Commonwealth Constitution.[3]

I leave it to others to predict what the future holds. However, it seems clear that the High Court is largely indifferent to the insights of economic analysis of law, and of corporate law. This is perplexing. The problem before the High Court concerned Articles of Association and, therefore, was fundamentally one of contract. Law-economics analyses of corporate law have looked to contract, not only as the basic analytical construct, but as the very foundation for the existence of corporations. While one may argue with the explanations and normative content of law-economics, it has been a powerful paradigm for systematic analysis of corporate phenomena.

The purpose of this chapter is threefold. First, the chapter will show how a law-economics analysis can produce significant insights into issues associated with expropriation articles and alterations of articles. Second, the chapter will demonstrate that the early development of law on these questions in Australia and England produced efficient and desirable outcomes. These two matters will be considered together in the first part of the chapter. It will be shown in this part that prior to *Gambotto*, the law entitled majority shareholders to exercise liberally the power of alteration of articles, in a manner consistent with what they considered (a) to be for the benefit of the company, and (b) the appropriate means of resolving shareholder conflicts. This entitlement was subject to a principle of fraud on the power of alteration. Third, in the second part of

1 Lecturer, Law Faculty, Griffith University. I wish to thank Stephen Bottomley and Ian McEwin for helpful comments. This article is a revised version of an article written by me under the title, "*Gambotto v WCP Ltd*: An Economic Analysis of Alterations to Articles and Expropriation Articles" (1995) 23 *Australian Business Law Review* 276.

2 (1995) 182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243.

3 See eg *Australian Capital Television Pty Ltd v Commonwealth* (1994) 177 CLR 106; *Cunliffe v Commonwealth* (1994) 124 ALR 120; *Theophanous v Herald and Weekly Times Ltd* (1994) 68 ALJR 713.

the chapter, a law-economics lens is used to examine critically the decision in *Gambotto*, where this approach was destroyed.

Control of Majority Shareholders Voting for Alteration of Articles

Context of contentious alterations

If the corporation is conceptualised as a "nexus of contracts",[4] it is defined as a specialist contracting intermediary, delineated by the contracts entered into by persons interested in the output and cash flows produced. The articles are part of that contractual machinery. They specify rights between shareholders and the corporation, eligible officers and the corporation, and shareholders inter se.[5] Alteration of these rights may adversely affect the entitlement of some or all shareholders to cash flows. There are two major cases of problematic alterations and the law protects shareholders in these cases in quite different ways.

First, managers may intend an alteration to transfer wealth from shareholders to themselves. Corporate law primarily deals with these sorts of opportunistic alterations by its "mandatory" content.[6] Many provisions of Pts 3.2[7] and 3.2A of the Corporations Law create compulsory terms that foreclose free negotiation of some terms of the contract between managers and the corporation.

Second, an alteration may discriminate between shareholders inter se, for example by variation of class rights or, as in *Gambotto*, the creation of an article that benefits a majority shareholder or shareholders at the expense of a minority. As will be shown below,[8] shareholders, unlike directors and some senior managers, are not subject to

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4 The concept of the corporation as a nexus of contracts has its origin in Coase, "The Nature of the Firm" (1937) 4 *Economica* 386, and was further explained in Jensen and Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) 3 *J Fin Econ* 305. Some of the major contributions in the legal discipline to the literature on the nexus of contracts can be found in Symposium, "Contractual Freedom in Corporate Law" (1989) 89 *Columbia L Rev* 1395, and Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991), Ch 1.

5 Corporations Law, s 180. Are statutory contracts with the corporation inconsistent with the nexus-of-contracts hypothesis? I consider that these contracts are with the corporation for reasons of contracting economy. If enforcement of contracts was costless, shareholders and managers could be in privity of contract and managers could be sued by shareholders. However, in a world where contracts are costly to write and enforce, the vesting of rights that would otherwise belong to shareholders in a fictitious legal person allows for the economical enforcement of these rights: cf Posner, *Economic Analysis of Law* (3rd ed, Little, Brown and Company, Boston, 1986) at 389. It also solves any problems of free-riding in shareholder litigation, as the corporation, and therefore, all shareholders, bear these costs equally. A similar explanation applies to the contract between the corporation and shareholders. Where shareholders must enforce rights arising from common association, it would be highly inefficient to sue all shareholders. This explanation conforms to Coase's thesis that the firm is a means of economising on contracting costs: Coase, supra n 4.

6 Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 *Columbia L Rev* 1549.

7 See ss 224, 227-229, 231-232A, 235-239, 241-242.

8 See text accompanying n 11.

non-negotiable fiduciary duties. Given that mandatory statutory terms have similar content to or reinforce fiduciary duties, this may explain why alterations of this sort are not confined by mandatory substantive law. These alterations are, however, subject to mandatory *procedural* law. Variation of class rights is subject to a specific statutory procedure.[9] Other forms of alterations have historically been tested by whether there was a fraud on the power of alteration. The focus below will be to analyse this test in general, and to study its application to articles that permit the expropriation of minority shareholders in particular.

It is important to characterise the economic context in which clashes between minority and majority shareholders take place. Minority shareholders often refuse to agree to sell their shares, even where the price offered is objectively fair and would compensate any loss.

Minority shareholders may be aware that majority shareholders benefit substantially from owning all ordinary shares (eg because of the availability of grouping tax losses). Holding constant the value of the share as an interest in net assets, and assuming the benefits of 100% ownership to be significant, the value of the outstanding shares to the majority shareholder must rise in exponential, inverse proportion to the number of minority shares outstanding. Although not true in every case, minority shareholders may hold out in order to obtain as large a share of this prospective increase in value as they can. In publicly listed companies, hold-out behaviour cannot easily be explained by any other motivation, since shares are essentially fungible and, in a diversified portfolio, a perfectly substitutable commodity.[10] Is this self-protection, shrewd bargaining or opportunism? One's "mileage" may vary.

By holding out, the minority shareholder holds the corporation to ransom by expropriating benefits that properly accrue to the corporation. Admittedly, the ransom is paid by the majority shareholder and the benefits that belong to the corporation are reflected in the value of the shares of the majority shareholder. However, the conduct of the minority shareholder prejudices the corporation while he or she "holds out" because the corporation is prevented from increasing its value. Thus, a resolution by majority shareholders to adopt a "compulsory acquisition" article may be motivated by the interests of the corporation as a whole, as well as self-interest. In the extreme, hold-out behaviour may cause some value-maximising action never to be taken, for example, because the opportunity passes. If that happens, shareholders and society itself loses.

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9 Sections 197-199.

10 There may be cases where a shareholder's loss of membership cannot be readily compensated because of unique privileges or entitlements conferred by membership (eg in some "family" companies). Thus, the value of the share as an interest in net assets diverges markedly from its value to the shareholder. In such cases, identifying a party deserving the protection of the law is easier. This analysis is similar to the analysis of "specificity" in contractual relationships by "transaction cost" theorists such as Williamson (see *Economic Instiutions of Capitalism* (Free Press, New York, 1986))

It is not argued that the motivation of minority shareholders should be dispositive of the validity of an expropriation alteration. However, it is instructive to remember that in many of these conflicts, both contestants will act in self-interest. Neither makes a convincing claim for the indulgence of the law. It is submitted that the better alternative to siding with one of the combatants is to examine rigorously whether there has been fraud on the power of alteration. This has been the position that the law has historically taken. The approach that will be taken below is to consider the English and Australian cases that represent the most important contributions to the development of this law. The economic logic of this doctrine will be analysed.

The classic test of fraud on the power of alteration: Allen's case

The exercise of voting power by majority shareholders is not subject to fiduciary obligations owed to minority shareholders. This is appropriate, as Dixon J pointed out in *Peters' American Delicacy Co Ltd v Heath*[11] (*Peters'* case), since such shareholders are only exercising their several rights of property in a co-ordinated way. Nonetheless, there are limitations. A difficulty for shareholders is that they do not have the benefit of their "own" contract. Instead, each shareholder is part of a group that contracts with the corporation on the same terms. While parties to a contract can agree to vary their contract, a problem can arise if the rights of persons who contract severally with the corporation can be changed by less than unanimous agreement by them. Accordingly, a doctrine of "fraud on the power" was developed. Never definitively stated, the doctrine seems to refer to the purposes for which the power was granted, the nature of the company, and the gains and advantages which might legitimately be pursued by the power's exercise.[12] One would think that in making these inquiries it would also be legitimate to consider the benefits conferred by shareholding and the detriment suffered by, and compensation offered to, shareholders on expropriation. How this limitation has been applied is our principal concern.

A classic, although incomplete formulation of this limitation on the exercise of majority voting power was given in *Allen v Gold Reefs of West Africa Ltd*[13] (*Allen's* case). The case involved an alteration of articles that entitled the corporation to a lien over fully-paid shares in respect of debts that members owed to the corporation. In relation to the exercise by the majority of this power, Lord Lindley (then Lindley MR) said that the power had to be exercised "bona fide for the benefit of the company as a whole, and it must not be exceeded".[14] While the language differs, the test is consistent

11 (1939) 61 CLR 457 at 504.
12 Ibid at 511.
13 [1900] 1 Ch 656.
14 Ibid at 671.

with the goal of maximising corporate value.[15] Value maximisation is in the interests of *all* parties with a claim on the corporation's cash flows and output.[16] If the claims of the parties interested in the corporation's cash flows and output are held constant in value, maximisation will be "pareto" optimal.

The test strikes an appropriate balance between corporate and shareholder interests. So far as corporate interests are concerned, where an alteration benefits the corporation as a whole, it should be valid. This is logical, because an alteration that benefits the company could not *normally* be a fraud on the power. It is in this sense that "benefit to the company as a whole" detects an absence of fraud on the power. However, the test is qualified by good faith. "Good faith" focuses primarily on the manner of exercise of the power and objective circumstances surrounding the exercise. While a requirement of good faith operates to protect shareholders against oppression, it is not a guarantee of shareholder rights. The test would strike down, for example, an alteration that increases the value of the corporation by sacrificing the interests of certain shareholders. Despite satisfying the prima facie test, that sort of alteration may be offensive because the power of alteration was not conferred so a majority might profit from the annihilation of the minority. The cases discussed below show that the law traditionally leaves shareholders to decide what is for the benefit of the company. The court does not interfere unless the resolution *could* not honestly be decided to be for the company's benefit.[17]

The test in *Allen's* case tolerates a resolution that causes incidental detriment to some shareholders.[18] The facts of *Allen's* case show that an alteration may, in certain circumstances, transfer wealth away from certain shareholders, but may not be offensive because it benefits the corporation as a whole and is not intended to effect an unfair

15 Dixon J in *Peters'* case (1939) 61 CLR 457 at 512, described "benefit as a whole" as a "very general expression negativing purposes foreign to the company's operations, affairs and organisations." The case law reveals a confusing history of defining "corporation as a whole", where the courts have tried to determine whether the phrase means the corporation as a commercial entity, or the general body of shareholders or both (or something else). Rixon (1986) 49 *Mod L Rev* 446 at 449 points out that Lord Lindley implied in *Allen's* case [1900] 1 Ch 656 that "corporation as a whole" meant the corporation as an independent, commercial entity. The change came in *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286, which adopted the test of a general body of corporators, notionally represented by a hypothetical member neither of the majority or the minority (at 291). The distinction is largely specious. It will be rare that something in the interest of the commercial entity is not in the interest of the hypothetical shareholder. The exception is where the resolution prejudices a subset of shareholders, ie, a purely redistributive resolution. In these cases, it is submitted in this chapter, consistent with *Peters'* case, that the appropriate inquiry is not as to the benefit of the company as a whole, but whether there is fraud on the power exercised. Rixon, at 466-468 points out that the change in *Greenhalgh* was necessary because it was a redistributive case, like *Peters'* case, in which the commercial entity test would not be helpful. This basic point, which is fundamental to understanding *Peters'* case, was completely ignored by the High Court in *Gambotto*.

16 As to the problem of choosing other objectives, see Arrow, *Social Choice and Individual Values* (Cowles Foundation Monograph, 1963).

17 *Sidebottom v Kershaw Leese & Company* [1920] 2 Ch 124 at 136; *Shuttleworth v Cox Brothers & Company (Maidenhead)* [1927] 2 KB 9 at 22 and 26.

18 *Peters'* case (1939) 61 CLR 457 at 480 (Latham CJ, McTiernan J agreeing).

redistribution. This has two positive aspects, from an economic perspective. First, it acknowledges the reality that alterations change rights and the division of cash flows. A rule that strikes down every alteration that under some circumstances could prejudice some shareholders would not serve the best interests of corporations. It would encourage litigation and interference in corporate affairs. Its tendency to maintain the status quo is likely to obstruct value maximisation. Secondly, by emphasising "benefit", the rule focuses majority shareholders on fair means of maximising value. Simultaneously, by testing the alteration "as a whole", it decreases emphasis on distributive questions and leaves these to the parties to decide by agreement and according to other provisions of their contracts. It is a classic laissez-faire principle, and has an obvious efficiency motivation.

Seen in this way, *Allen's* case encourages the pursuit of value maximisation. However, invalidity may follow in cases where value maximisation is employed as a cynical disguise for self-aggrandisement. Nonetheless, these principles encounter difficulty when the alteration of articles does not purport to represent a benefit to the corporation, even though a majority of shareholders are in favour of it. One approach might be to prevent them altogether because there is no demonstrable benefit: thus, the test in *Allen's* case is not literally satisfied. This would be to convert the essentially negative test of fraud on the power into a requirement that, to be valid, an alteration had to benefit the company, *and* be adopted in good faith. This approach was taken in *Brown v British Abrasive Wheel Co*[19] and *Dafen Tinplate Co v Llanelly Steel Co*[20]. It is fundamentally incorrect, as shown in subsequent English[21] and Australian[22] authority. That approach would also be undesirable, from a contractarian point of view. Law-economics scholars stress that particular corporations survive over time, because they are capable of making contractual promises that persons find both believable and attractive.[23] In a dynamic economy, this process necessarily implies that at the individual firm level, the corporation must be adaptive and evolutionary.[24] Easterbrook and Fischel point to the inevitable association between contract and adaptation.[25] If that is correct, an approach which makes change more difficult, by creating a presumption against it (as is implicit in positive requirements) decreases the ability of corporations to survive by evolution and adaptation.

Redistributive alterations: Peters' case

Having rejected the naive interpretation of the test in *Allen's* case, it remains to be asked what the test is when considering an alteration that does not demonstrably benefit the corporation but which a majority of shareholders support. The answer to this question is given by *Peter's* case, which not only resolves this question conclusively,

19 [1919] 1 Ch 290.

20 [1920] 2 Ch 124

21 *Shuttleworth v Cox Brothers & Co (Maidenhead)* [1927] 2 KB 9.

22 *Peters'* case (1939) 61 CLR 457 at 509-510.

23 Easterbrook and Fischel, supra n 4 at 4

24 See, generally, Alchian, "Uncertainty, Evolution, and Economic Theory" (1950) 58 *J Pol Econ* 211.

25 Easterbrook and Fischel, supra n 4 at 13-14.

but does so with reference to principles that sit comfortably with those articulated in *Allen's* case.

Peters' case involved an alteration of an article relating to capitalising profits by issuing bonus shares. Dividends were divisible among members proportionately to amounts paid up on shares, while the article relating to capitalisation by bonus issue provided that shares should be issued in proportion to the number of shares held by members. The corporation had fully paid and contributing shares. The directors considered that it would be inequitable to distribute bonus shares according to the articles given the inconsistency. The articles were altered. The minority alleged that the change was invalid as it was motivated by the intention to benefit fully paid shareholders and to disadvantage partly paid shareholders. The High Court held unanimously in favour of the alteration. This case demonstrates that the test of alterations is fraud on the power, but that the specific test in *Allen's* case - of which all of the judges approved - is not useful where the alteration is designed to resolve conflicting rights of shareholders, and does not otherwise advance the benefit of the corporation.

Latham CJ pointed out that the test in *Allen's* case cannot be used for changes of articles that affect the relative rights of classes of shareholders.[26] These rights could be changed, even to the detriment of shareholders, provided the power had not been exercised oppressively or fraudulently.[27] While reasonable persons might hold different views as to fairness on capitalisation, the method adopted here was not unfair. McTiernan J agreed.

Dixon J rejected the notion that one could strike down an alteration with reference to a test that assumes the permanence of rights of shareholders. His Honour said that there is no scope for "general notions of fairness and propriety"[28] in matters concerning the rights of shareholders under the articles. His Honour seems to make two points. First, a resolution passed regularly with the single aim of advancing the interests of the corporation considered as a whole, must fall within the scope of the statutory power to alter the articles.[29] Secondly, in cases of resolutions which merely adjust and balance the rights of shareholders, a test that looks to the existence of the benefit of the corporation as a whole gives indeterminate results. The benefit of the corporation is neither advanced nor decreased.[30] Another way of putting this point is that the issue is no longer one of maximising value but, rather, one of redistributing rights to that value. In these cases, one must examine whether there is a fraud on the power having regard to objective circumstances, particularly prevailing rights and the effect of the alteration. If, as in *Peters'* case, the resolution is not oppressive, it does not make an unjust or reprehensible appropriation and the objective purpose is not beyond the scope of the

26 (1939) 61 CLR 457 at 481-482.
27 Ibid at 482.
28 Ibid at 507.
29 Ibid.
30 Ibid at 508-512.

power, the resolution is valid.[31]

Peters' case accords with the above analysis of *Allen's* case. *Peters'* case requires an examination of the function of the alteration. An alteration directed to the benefit of the corporation will generally be valid, except where the power is exercised fraudulently. A power is exercised fraudulently where an attempt by the majority shareholder to secure some gain cannot be countenanced as a purpose for which the power of alteration is conferred. One can think of few, if any, cases where an alteration genuinely benefits the corporation as a whole, and simultaneously secures a gain for the majority outside the contemplation of the power of alteration. This is consistent with the "pareto" optimality of value maximisation.[32] Generally, the majority gains because the corporation benefits from the alteration. However, if the alteration does not benefit the corporation, but resolves some conflict between shareholders, the test of benefit sheds no light on the existence of fraud. This problem must be answered by reference to various factors, including those Dixon J noted. Dixon J and the other members of the court affirmed the correctness of Lord Lindley's test, but pointed to the indeterminacy of "corporation benefit" in alterations primarily involving redistribution of rights. The judgments underline the entitlement of shareholders to exercise their voting rights for their benefit, provided there is no fraud on the power.[33]

The limitation of the touchstone "benefit of the company" in *Peters'* case reflects the fact that many alterations to articles will have only a redistributive effect, rather than affecting the corporation as a whole. Dixon J implied this when he said:

> A power to alter articles of association is necessarily a power to alter the rights of shareholders *inter se*, including their mutual rights in respect of profits and surplus assets. It is therefore evident that some difficulty must arise in applying to resolutions for the alteration of articles a statement of principle which assumes the independent existence of rights which should not be impaired or destroyed.[34]

Yet, some alterations do benefit the corporation as a whole: *Allen's* case was one; *Sidebottom v Kershaw, Leese & Co*[35] was perceived as another. In such cases, the principal focus is on the existence of a real benefit. However, "fraud on the power" remains the crucial negative test which ascertains that the benefit is to the corporation *as a whole* rather than to a single shareholder or group. To take the view that a specific inquiry into the alteration's benefit to the corporate entity has no place in the law is a conclusion that the court did not reach, and could not have reached on the facts of the purely redistributive case before it in *Peters'* case.

The inverse of the "latecomer term" problem: expropriation articles at incorporation

Apart from its implications generally as to the appropriateness of the test of alterations

31 Ibid at 513.
32 See n 16 and accompanying text.
33 Rixon, supra n 15 at 466-470 takes a similar view of the case.
34 (1939) 61 CLR 457 at 506.
35 [1920] 1 Ch 154.

of articles, economics also informs criticisms of a related point. This is whether it is possible to alter articles to include, for the first time, a provision allowing the majority to expropriate a minority. *In re Bugle Press Ltd*,[36] Harman LJ stated[37] that it was a fundamental rule of company law that majority shareholders could not expropriate a minority, *unless the articles contained an expropriation provision from the outset*.[38] First, this is simply incorrect. In *Sidebottom v Kershaw, Leese & Co*,[39] Warrington LJ referred to this exception and said that the legislation allowed a corporation to do by alteration what might have been done by the original articles.[40] The decision in that case was that it was possible to include an expropriation article for the first time. *Allen's* case was cited as authority.[41]

Secondly, if one assumes Harman LJ's major premise to be correct as a rule, then its exception seems perverse. What would happen if a corporation was incorporated with a power of compulsory acquisition of shares by a shareholder on reaching, for example, ninety per cent? The price at which this corporation could sell its shares would be below their value as an interest in net assets. Investors will pay less for such shares than they would for shares in an identical corporation not having such an article. Nonetheless, if no member holds, or is in a position readily to acquire, such a shareholding, the discount will be minimal given the unlikelihood of the exercise of the power. The discount will increase as the probability of the exercise of the power increases. However, the discounted value of these shares should never be less than the compensation the expropriated shareholder can be expected to receive if the power is exercised. If that compensation is to be a fair price independently determined, there may be no discount at all. Thus, it is impossible to see how minority shareholders of this corporation are better off than those of an identical corporation that adopts the same article after incorporation. It seems perverse that an article included at the time of incorporation which provides for no or inadequate compensation is valid, whereas one included after incorporation that provides for compensation to be established by an independent assessment of the fair value of the shares is invalid.

An Economic Analysis of Gambotto

Important facts and aspects of the High Court judgment

There are two crucial facts in *Gambotto*. The first is that the expropriation was to take place at a price that was objectively fair, and was conceded as such by the defendant. Secondly, there was evidence that the principal purpose of the alteration was to enable

36 [1961] Ch 270.

37 Ibid at 287-288. Emphasis added.

38 Mason CJ, Brennan, Deane and Dawson JJ agreed with this proposition in *Gambotto v WCP Ltd* (1995) 182 CLR 432 at 445. Their Honours then contradicted this assertion by stating a test (at 445), compliance with which would validate an alteration creating an expropriation article after incorporation.

39 [1920] 1 Ch 154.

40 Ibid at 170.

41 Ibid at 162, 164 and 165.

the corporation to take advantage of very significant tax losses. This would enable the company to avoid paying income tax of approximately $ 4,235,000. The principal analysis will be of the decision of the High Court, where the alteration was struck down unanimously.

In a joint judgment, Mason CJ, Brennan, Deane and Dawson JJ concluded, at variance with the analysis above, that *Peters'* case required the conclusion that the expression "for the benefit of the corporation as a whole" is inapplicable in the context of an alteration of the articles designed to effect or authorise the expropriation of a minority's shares.[42] Their Honours held that the exercise of power to alter the articles to create an expropriation provision, would only be valid if it is exercisable for a proper purpose and its exercise will not operate oppressively in relation to minority shareholders.[43] Note that the imposition of two positive tests is a disguised reintroduction of the aberrant tests used in *Brown v British Abrasive Wheel Company*[44] and *Dafen Tinplate Co. v Llanelly Steel Company*[45] to which one thought *Peters'* case had dealt fatal blows.[46] More importantly, from an economic perspective, this type of test might eventually become the standard test of all alterations of articles by a majority. If so, it would erode the contractual, and, therefore, the evolutionary aspect of the corporation on which its survival depends.[47]

Their Honours considered that an expropriation article might be for a proper purpose if it avoided detriment to the corporation caused by the continued shareholding of the minority shareholder. McHugh J criticised the distinction between expropriation eliminating detriment to the corporation and expropriation causing the corporation to receive a substantial benefit.[48] Clearly, the distinction is without economic substance. The example of expropriating shareholders in order to maintain a television licence (which is apparently valid if the terms of the expropriation are not oppressive) and expropriating shareholders in order to secure a commercial advantage that the majority shareholders will enjoy (which is invalid) is hopelessly feeble. In both cases, the corporation gains from the expropriation, and the majority shareholders enjoy the benefit of the gain. In this case, the company did seek to avoid a detriment, namely imposition of income tax on the sale of properties.

Their Honours also required that expropriation be "fair".[49] This analysis is less problematic, because expropriation was conceded not to be on unfair terms. Both their Honours and McHugh J require the procedure followed and the price to be fair. Their Honours' and McHugh J's analyses of markets and prices will be discussed in the next section.

42 (1995) 182 CLR 432 at 444.
43 Ibid at 445.
44 [1919] 1 Ch 290.
45 [1920] 2 Ch 124.
46 See text accompanying nn 18-22.
47 See text accompanying nn 23-25.
48 (1995) 182 CLR 432 at 455.
49 Ibid at 447.

Market efficiency and pricing

Economic analysis seems out of favour with the High Court. Matters such as alteration of articles to allow for expropriation are conducive to economic analysis, as shown above. Yet, the court avoids such reasoning entirely, in favour of judicial legislation that ignores precedent. It is instructive to consider the court's analysis of the fairness of the price an expropriated shareholder receives.

The majority said that a shareholder's interest cannot be valued solely by the current market value of the shares.[50] Fairness of price offered depends on various factors, including assets, market value, dividends, nature of the corporation and its likely future. The comments do not differentiate between the situation of shares that are not publicly traded (where the comments may have some validity) and those that are. In the latter situation, the majority's comments assume a model for the market pricing of shares that does not take into account these matters. There are at least two theoretically defensible and empirically supported models for valuing a share, namely, the Capital Asset Pricing Model (CAPM)[51] and Black and Scholes' Option Pricing Model (OPM).[52] These models can easily accomodate the factors (many of which are, of course, statistically collinear) such as those their Honours mentioned, inter alia, in a systematic, unbiased fashion.

McHugh J proceeds on the basis that there are no theories of pricing, that the market exemplifies irrationality, and that the only solution lies in judicial wisdom, which will ascertain the "fundamental value" of a share.[53] Sadly, his Honour bases these comments on his observation that shares fluctuate in value, some unidentified anecdotal evidence and an implicit though apparent conviction that markets are dominated by irrationality.

This is not the place to examine the theory of efficient capital markets, but brief comments can be made. The theory asserts that markets for financial instruments impound into price all information relevant to the return on the instrument either before or when the information becomes publicly available.[54] Thus, while prices may not be perfect, they are not systematically lower or higher than the price a perfect valuation model would produce on the basis of every relevant piece of information. A corollary is that it is impossible to earn, on a systematic basis, supracompetitive profits by analysing

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50 Ibid at 447.

51 The original statements of the theory can be found in Lintner, "Security Prices, Risk and Maximal Gains from Diversification" (1965) 20 *J Fin* 587; Mossin, "Equilibrium in a Capital Asset Market" (1966) *Econometrica* 768; and Sharpe, "Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk" (1964) 19 *J Fin* 425.

52 The original statement of the theory can be found in Black and Scholes, "The Pricing of Options and Corporate Liabilities" (1973) 81 *J Pol Econ* 637.

53 (1995) 182 CLR 432 at 457-458.

54 Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 *J Fin* 383 at 384. For application to Australia, see Blair and Ramsay, "Mandatory Corporate Disclosure Rules and Securities Regulation" in Walker and Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) 264 at 277-280.

public information to identify whether the market overvalues or undervalues a share. Langevoort[55] points out that empirical tests of the theory between the time of its inception in the late 1960s and the mid-1980s generally supported the theory's basic assertion. Langevoort discusses the fact that subsequent evidence has started to demonstrate that the pricing of shares is partially "noisy", that is, prices incorporate factors besides rational expectations of cash flows and risk.[56] "Noisy pricing" has been theorised to be attributable to behavioural factors and cognitive limitations of investors.[57] However, even the proponents of noisy pricing recognise that their theory offers no insights on valuation of shares and, more importantly, does not allow for the systematic, profitable identification of mispriced stocks. Moreover, as Langevoort points out, "noisy pricing" means that markets are not perfectly efficient, but that many insights and applications of the efficiency thesis remain good.[58]

These matters are simply ignored by the court in *Gambotto*. A court should value shares not publicly traded, since these markets are likely to be inefficient, given higher transaction costs, illiquidity and poorer information. However, for shares publicly traded, the notion that a judge (assumed to be untrained in finance), on the basis of evidence selected by the litigants, can systematically outperform a market in which experienced persons and institutions, with access to high quality information, stake their reputations and fortunes in a battle on market prices, seems ludicrous. Perhaps, courts lower in the hierarchy may make less extravagant claims to omniscience. As Easterbrook and Fischel say:[59]

> [I]t does not matter if markets are perfectly efficient, unless some other social institution does better at evaluating the likely [price] effects ... The prices will be more informative than the next best alternative, which is all anyone can demand of any device.

An economic analysis of alterations to articles

It has been submitted on the basis of *Peters'* case that cases must be classified as either merely redistributive or as raising the issue of substantial benefit for the corporation.

When an alteration to articles does not affect the corporation as a whole, but redistributes rights to corporate cash flows, a court required to adjudicate such matters needs to consider three issues. First, the court is obliged to protect the contractual

55 Langevoort, "Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited" (1992) 140 *Univ Pennsylvania L Rev* 851.

56 Ibid at 866-872.

57 See eg Andreassen, "On the Social Psychology of the Stock Market: Aggregate Attribution Effects and the Repressiveness of Prediction" (1987) *J Personality and Social Psychology* 490; De Bondt and Thaler, "Does the Stock market Overreact?" (1985) 40 *J Fin* 793; Klausner, "Sociological Theory and the Behaviour of Financial Markets," in Adler and Adler (eds), (1984) 2 *The Social Dynamics of Financial Markets* 57; Shiller, *Market Volatility* (MIT Press, Cambridge, 1989); Thaler and Ziemba, "Anomalies: Parimutuel Betting Markets: Racetracks and Lotteries" (1988) *J Econ Pers* 161.

58 Langevoort, supra n 55 at 871.

59 Easterbrook and Fischel, supra n 4 at 19.

rights of parties to the contract, subject to powers contained in the contract or implied by law for the change of those rights. The power to change the articles is as much a right of the majority as the property right of the dissentient shareholder. This balance can be struck by ensuring that the majority does not commit a fraud on the power to change the articles. This test is like fiduciary principles in one sense: both are essentially open-ended and based on a negative standard, and protect shareholders against opportunistic contractual behaviour unforeseeable in detail at the time of incorporation.[60]

Secondly, a redistributive case is basically a "zero-sum" game. Ex hypothesi, there is a winner and a loser, but in aggregate no-one is better off. The law should discourage litigants from bringing these actions, except, as noted above, where there is a fraud on the contractual power of alteration. The non-interventionist rule, with its clear exception, is a consequence of balance between two things: (1) Litigation is costly. It consumes the litigants' resources, and may distract managers from maximising value for all parties. (2) It is necessary to preserve recourse to the courts by persons with legitimate grievances. Otherwise, confidence in the corporate form will be lost. The advantages of the corporation for conducting business will be undermined by perceptions that majorities can deal unfairly with minority rights.

Thirdly, redistribution is pervasive in a capitalist economy. Markets necessarily operate redistributively, a fact that observers of markets from many disciplines have recognised. Corporations, as economic units in the marketplace that are run profitably (unprofitably), are the beneficiaries (victims) of this process. This effect can operate redistributively within the corporation. For instance, if a corporation changes its investment policy from passively conservative to aggressively risky, then ceteris paribus, some shareholders - primarily those who have not diversified - lose, and some shareholders - those who by diversification bear little security specific risk - gain. Courts should interfere only with redistribution only if there is a fraud on the power being exercised to effect the redistribution. It is impossible to diversify against fraud,[61] but in simple redistribution cases a shareholder will (on average) be a loser as frequently as a winner. So, encouraging litigation in cases without fraud is socially wasteful. More insidiously, if an interventionist rule is adopted, the court makes its own redistribution.

These matters explain the logic of *Peters'* case, which was purely redistributive. One looks not to the fact that some shareholders are "losing", but to the existence of a power to effect the redistribution, regularity of its exercise and the existence of any fraud on that power. As indicated, shareholders are vulnerable because all have a contract that contains the same terms as each other. Thus, investors need protection from fraudulent alterations, but otherwise should be taken to assume voluntarily the risk of redistributive alteration, since they benefit from the economy of shareholder-corporation contracting.[62]

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60 Ibid at 92-93; Gordon, supra n 6 at 1595-1596.

61 Gordon, supra n 6 at 1595.

62 See n 5.

Occasionally, a case will present for consideration an alteration to articles that, if implemented, would benefit the corporation. *Allen's* case is so regarded, as is *Sidebottom v Kershaw, Leese & Co*. It seems impossible to dispute that *Gambotto* was such a case. All of the alterations in these cases, if put into effect, involved persons forgoing some right, such as membership, or becoming subject to some detriment, such as a lien. In *Gambotto*, there was a certain gain to the corporation's assets to be had by the acquisition; the other two cases were concerned with avoiding a detriment. Both situations benefit the corporation as a whole.

The view that one takes of corporate "purposes" influences the priority accorded to value maximisation. If one takes the view that the corporation is a type of organisation, like society, a voluntary association or a church, ostensibly much may be said for principles that protect "corporate" rights.[63] Yet, the corporation differs to these other organisations. Incorporation was intended as an efficient organisational means for profit-generating enterprises to raise finance. Accordingly, value maximisation should be central, even though the means of maximisation should be qualified by equitable considerations. A more important difference is that, unlike other organisations, the corporation emphasised (and perfected) the concept of transferability of membership by making the share a fungible commodity that could be bought and sold. Accordingly, principles of democracy seem much less applicable when one can, without loss, cease to be a member and obtain full value for one's membership rights if one does not like management policies. If that is correct, the focus becomes the protection against fraud on corporate powers, not the guarantee of permanent shareholder rights. Certainly, some corporations do not exist to maximise value or pursue profit (although WCP Ltd was not one). In these cases, the test of fraud on the power remains, but the nature of the corporation is pertinent to understanding the purposes for which the power of alteration may be exercised.

On this basis the test in *Allen's* case, as clarified in *Peters'* case, achieves the necessary balance. If the alteration achieves a genuine benefit to the corporation by maximising the value of its assets, the alteration should stand unless, to use Latham CJ's test in *Peters'* case, the alteration was "so extravagant that no reasonable person could believe that it was for the benefit of the corporation" and thus a fraud on the power.[64] The application of the test involves comparing the benefit to the corporation with the detriment the shareholder impugning the resolution suffers, which will not exist if the shareholder is entitled to fair value for anything of which he is deprived. In a case where the alteration is intended to transfer wealth from the minority to the majority shareholders, there is clearly no benefit to the corporation as a whole. The matter is merely an opportunistic redistribution and is offensive as a fraud on the power. As was the practice earlier in the century, courts must give credit to the shareholders in assessing

63 It is worth remembering that these institutions reserve the right to expel members. The law does little to intervene in these cases, besides construing the contract, and ensuring in some cases that the organisation observes natural justice.

64 (1939) 61 CLR 457 at 482. Quoted with approval by Meagher JA of the New South Wales Court of Appeal in *WCP Ltd v Gambotto* (1993) 11 ACLC 457 at 460.

what is for the benefit of the corporation.[65] It is their investment, not the court's.

Conclusion

The decision in *Gambotto* is unjustifiable. The court ignored clear precedent and a balanced rule of law. The court gave an interpretation to *Peters'* case that suited the revision to the law that the court intended to make, while ignoring the distinction between the redistributive facts in *Peters'* case and the obvious evidence of benefit in the case before the court. The court's ominous dismissal of market prices in favour of its own ponderous valuation process spells uncertainty for corporate transactions that explicitly rely on "fair" values.

In a sense, the High Court is not acting in the longer-term interests of minority shareholders. While it assists opportunistic shareholders holding out for a larger share of the benefits of 100% ownership, it leaves the minority shareholder vulnerable to oppressive management by the majority shareholder. It seems logical, perhaps inevitable, that a corporation almost wholly owned by one or more corporations in a corporate group may be managed for the benefit of the group, rather than for a person who is a shareholder only of the corporation.[66] *Gambotto* is unlikely to change this. The dominance of a single shareholder group may cause a change in managerial and financial goals. The shareholder has remedies, of course, under s 260, but it seems perverse to "protect" a shareholder from being expropriated at a fair price, only to allow him or her a right to be bought out at a later point in time. By forbidding expropriation, and thus evolution, the court reinforces and perhaps aggravates the unstable conflict that exists in such companies. This result does not commend itself at all.

The rule that the court has established harms society. Society loses if a corporate group refuses to pursue a profitable project because of the need to share its profits with the minority and the project lapses because it could only be profitably pursued by the corporation concerned. Also, if the corporation cannot prevent minority shareholders selling shares to third parties, these third parties will rationally tend to pay more for such shares than they are worth as an investment in the company because of the shares' high "hold-out" value. Since the rule in *Gambotto* increases the hold-out value by discouraging expropriation at fair-prices, it distorts the value of these shares and encourages inefficient allocation of investment.

Ultimately, *Gambotto* is likely to achieve an increase in the role of the courts in corporate affairs and the obstruction of legitimate value maximisation. It seems that the price to be paid for corporate "rights" will be high.

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65 See *Shuttleworth v Cox Brothers & Company (Maidenhead) Ltd* [1927] 2 KB 9 at 27, per Atkin LJ.

66 This statement is one of probable fact, not of law. The law does not recognise duties to a corporate group: *Walker v Wimborne* (1976) 137 CLR 1 at 6-7. Such a principle, appropriately formulated, would be useful in resolving problems such as those in *Gambotto*, where majority shareholders attempt to act in a way that is for the benefit of the company as a member of a corporate group.

Chapter 9

When Should Compulsory Acquisition of Shares be Permitted, and, if so, What Ought the Rules be?

Saul Fridman[1]

There are a number of ways of viewing the *Gambotto* decision, as witness the various chapters contained in this book. Simply put, however, the facts of this case raise the fundamental question of what justification there might be for compelling a shareholder to part with his or her investment in shares.

At the outset, I should point out that Australian corporate law recognises a number of different methods by which a shareholder might be compelled to part with shares. The Corporations Law contains several provisions which either expressly or by implication authorise a majority shareholder to acquire shares of the minority by compulsion. Two of those mechanisms (the compulsory acquisition procedure contained in the takeovers code, Chapter 6 of the Corporations law, section 701 and selective capital reduction by the procedure set out in section 195) are the subject of other chapters in this book.[2] In addition to those, another possibility is the use of the scheme of arrangement under section 411. These and other methods of compulsory acquisition possible under the Corporations Law are considered in some detail in the recent report of the Companies and Securities Advisory Committee.[3]

It is not my intention to provide an exhaustive review of the various methods by which a majority shareholder, intent on securing 100% ownership of a company's shares, might proceed. Rather, it is my view that, whatever the mechanism selected for this objective, the fundamental question raised remains the same. Therefore, ought not the law recognise this and provide a set of rules common to all such transactions?[4] In the *Gambotto* case, as we know, the majority shareholder elected to proceed by way of

1 Lecturer in Law, The Australian National University. The author is indebted to Nicholas Seddon for his insightful and lively comments concerning earlier drafts as well as to his colleagues Stephen Bottomley and Ian McEwin for helpful discussion.

2 See chapters 2 to 5.

3 Companies and Securities Advisory Committee, *Report by the Legal Committee on Compulsory Acquisitions* (January 1996).

4 A good example of statutory provisions designed to achieve this effect can be found in the Ontario Business Corporations Act RSO 1990 c B-16, ss 187-190, the essence of which is discussed below.

amendment of the company's articles. In this chapter, I will consider the approach taken by the High Court to this method of compulsory acquisition. As will be seen, the High Court rejected previous authority on the question of the appropriate test to apply to judicial review of amendments to a company's articles. Despite my general agreement with the High Court's assessment of previous authority, which many commentators had agreed was generally unhelpful,[5] it is my view that the approach put forward by the majority of the High Court is not likely to be any more useful.

It is my view that the essence of the problem here is the focus on property rights as pivotal. It will be shown that this focus leads to an inescapable conclusion that compulsory acquisitions are impermissible, despite the fact that many might agree that there will be some circumstances where the acquisition ought proceed. At the very least, simply deciding cases of this nature on the basis of the individual shareholder's right to elect to continue to hold shares does little to resolve the issue.[6] Anglo-Australian law recognises many types of property rights, most of which are defeasible. The question here is whether the property rights represented by share ownership are any different from other defeasible property rights. It is in the analysis of this question that a sensible approach to the evaluation of compulsory acquisition cases might be found.

The High Court Judgment in Gambotto

The essence of the decision in *Gambotto* dealt with the question of when a majority shareholder might, by amendment of the articles of association, compel minority shareholders to part with their shares for fair compensation. The litigation arose by

5 That line of authority commences with the case of *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 and finds its Australian expression in the case of *Peters' American Delicacy v Heath* (1939) 61 CLR 457, discussed below. For academic commentary on the difficulty of applying the principles laid down in these authorities, see generally F Rixon, "Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association" (1986) 49 *MLR* 446. An extremely succinct summary of this attempt to limit majority power be constraining the power to vote can be found in B Welling, *Corporate Law in Canada: The Governing Principles* (2d ed, 1991) 1991 Butterworths, at 627:

> Basic principles would indicate that the voting right is one of the property rights comprising the share and as such is unaffected by non-proprietary restraints. Unfortunately, some rather confused and contradictory authorities suggest that a vote must sometimes be cast "in the best interests of the corporation": the authorities seem quite vague about what this means. The so-called rule used to be trotted out in cases where the courts disapproved of majority manipulation of political power within the corporation, yet perceived judicial intervention to be frustrated by the basic principles of majority rule and corporate personality... Five English cases are typical of the confusion surrounding the point. They were decided between 1900 and 1927. Each sought to articulate some manageable standard for constraining the individual shareholder's vote. All failed.

6 This much was recognised in the CASAC Report, supra n 3 at para 1.13:

> The Legal Committee considers that compulsory acquisitons are an appropriate and accepted aspect of Australian commerce notwithstanding that they override the proprietary rights of individual shareholders. The regulatory objective is to balance the interests of all shareholders, to avoid either minority oppression or dictation.

way of a challenge to the amendment made by a minority shareholder who did not attend the meeting at which the appropriate special resolution was passed. The majority shareholder had abstained from voting. The price offered to minority shareholders for their shares was well in excess of the value determined by an expert valuer.

It is useful to review, if only in summary, the reasoning in the two judgments of the High Court before proceeding further.

The joint judgment

In their joint judgment, Mason CJ, Brennan, Deane and Dawson JJ considered the law applying to amendments to company articles. One positive feature of the joint judgment is that it clearly concluded that the test of considering whether the amendment was "bona fide for the benefit of the company as a whole" was inappropriate in the context of adjudicating a challenge to an amendment designed to effect an expropriation of minority interests.[7] Given the difficulty often encountered by courts in determining how to assess the "best interests of the company as a whole", especially in the context of internal contests between competing groups of shareholders, this development is to be applauded.

However, the critical aspect of the joint judgment concerns the means suggested of striking a balance between the interests of majority and minority shareholders. The joint judgment reasons that utilising the power to amend a company's articles for the purpose of expropriating the shares of minority shareholders presents different considerations than other cases of amendment of the articles.[8] In general, qua the majority, amendments to articles "will be valid unless ultra vires, beyond any purpose contemplated by the articles or oppressive as that expression is understood in the law relating to corporations".[9] In the context of an alteration purporting to add a power to expropriate, the judges state that such a power could not be taken or exercised "simply for the purpose of aggrandizing the majority."[10] In such case "an expropriateion may be justified where it is reasonably apprehended that the continued shareholding of the minority is detrimental to the company, its undertaking or the conduct of its affairs - resulting in detriment to the interests of the existing shareholders generally - and expropriation is a reasonable means of eliminating or mitigating that detriment."[11]

The majority judgment then introduces a curious distinction between expropriations for the purpose of avoiding some detriment to the company and those designed to secure a benefit for the company. As the judges state: the majority cannot "expropriate

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7 (1995) 182 CLR 432; 127 ALR 417; 16 ACSR 1; 13 ACLC 243, relying on *Peters' American Delicacy v Heath* (1939) 61 CLR 457 at 512 per Dixon J. In fact Dixon J went further and opined that the traditional test was "inappropriate, if not meaningless" where the amendment proposed to adjust the rights of conflicting interests.

8 (1995) 182 CLR 432 at 444-445.

9 Ibid at 444

10 Ibid at 445.

11 Ibid at 445.

the minority merely in order to secure for themselves the benefit of a corporate structure that can derive some new commercial advantage by virtue of the expropriation."[12] This conclusion is justified on the basis that the advancement of the interests of either the company as a legal and commercial entity or the majority is not a sufficient justification to interfere with the proprietary rights of the minority shareholders.

> To allow expropriation where it would advance the interests of the company as a legal and commercial entity or those of the general body of corporators would, in our view, be tantamount to permitting expropriation by the majority for the purpose of some personal gain and thus be made for an improper purpose.[13]

As the continued holding of shares by the minority did not, in the view of the majority of judges, constitute a detriment to the company, the alteration of articles for the purpose of adding the power to expropriate could not succeed as it was not for a "proper purpose".

The concurring judgment of McHugh J

McHugh J's judgment differed from that of the majority on one crucial factor. McHugh J did not see any distinction capable of being drawn between an expropriation for the purpose of securing some benefit for the company and one designed to avoid some detriment.[14] Accordingly, McHugh J was prepared to allow an expropriation where it would secure some significant benefit for the company or allow the company to pursue some "significant goal". However, as with the majority judgment, McHugh J added that the expropriation, even if justified in principle, cannot operate oppressively.

The question of whether or not the expropriation is oppressive will, qua McHugh J, depend ultimately on the question of whether the price offered is fair and whether the majority have acted fairly. The latter consideration will depend on matters such as disclosure sufficient to enable the minority to assess the fairness of the price offered and the timing of the transaction. In addition, disclosure of the purpose of the transaction would be required.[15]

Despite having concluded that the purpose of the alteration of articles in this case was a permissible purpose, McHugh J agreed in result with the majority on the basis that the disclosure provided to the minority shareholders was insufficient. Therefore, in his view, the expropriation was oppressive.

Do the High Court Judgments Make Sense?

There are several problems with both judgments in this case. The majority view

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12 Ibid at 446.

13 Ibid at 446.

14 "No distinction should be drawn between an expropriation that will enable a company to pursue a beneficial course of action that would otherwise be denied to it and an expropriation that avoids a detriment to the existing interests of the company." Ibid at 455.

15 Ibid at 459.

that there is a distinction between transactions designed to secure a benefit to the company and those designed to avoid a detriment must surely be a distinction without a difference.[16] Leaving aside, for the moment, the question of the value to be attached to the shares and the question of the individual shareholder's supposed right to hold them should he or she insist upon so doing, the matter of corporate benefit as balanced against the value of the individual's shares must surely be primarily an economic question.[17] If such is the case, this distinction clearly ignores the vital concept of opportunity cost.[18] In principal, there is no difference between the securing of a benefit and the avoidance of a detriment: both amount, in economic terms, to the same thing.

Once this distinction is ignored, the basis on which the majority concluded that the purpose of the expropriation was improper cannot withstand scrutiny. However, that is not the only problem with the reasoning of the majority. In addition, the securing of a benefit was not allowed as a permissible purpose on account of the fact that the benefit would, by definition, accrue only to the majority shareholder or shareholders. Accordingly, such a transaction could be characterised as one designed to aggrandize the majority. Again, whether a benefit is being secured or a detriment avoided, the result, if this reasoning is sound, would be identical. After the expropriation, it would only be the majority who would reap the benefits of the transaction (whether they be in the form of positive benefits, such as tax and administrative savings, as in *Gambotto*, or in the form of the elimination of some harm or detriment). Furthermore, the equation of the majority of shareholders with the corporation for this purpose ignores the fundamental principle that a corporation is an entity separate in law from the shareholders.[19] While it may appear attractive to come to the same conclusion as the majority on this point, to do so ignores the essence of the company as a commercial entity and as a result ignores the indirect benefits that may flow to other stakeholders in the corporation, such as employees and creditors.[20] Accordingly, there are both principled and practical objections to this conclusion.

While on this point, there is one further practical problem with the reasoning of the majority. The majority judgment concedes that an expropriation for the purpose of

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16 As indeed McHugh J, in his judgment, recognises explicitly in the passage quoted in note 14 above.

17 I note that the majority judgment rejected the view that a share could be viewed simply as a "capitalized dividend stream". However, as will be discussed below, while asserting that the share confers "proprietary rights on the investor", the majority did not give any indication of the significance of those rights, their nature, or why in any event those rights were not susceptible to an economic valuation.

18 This concept is clearly and lucidly described in a legal context in RH Coase, "The Problem of Social Cost" (1960) 3 *J Law & Econ* 1.

19 A fundamental norm of corporate law that has been judicially recognised since Salomon's case and hardly needs supporting by further authority today. It is recognised by ss 123 and 161 of the Corporations Law.

20 There have been numberous recent articles and comments relating to the importance of the creditor as a corporate stakeholder. See for example J S Ziegel, "Creditors as Corporate Stakeholders: The Quiet Revolution - An Anglo-Canadian Perspective" (1993) 23 *Univ Toronto LJ* 511. On the question of employees as corporate stakeholders, see J W Singer, "Jobs and Justice: Rethinking the Stakeholder Debate" (1993) 23 *Univ Toronto LJ* 475.

eliminating a minority shareholder's interest that is detrimental to the company or its affairs or undertaking is within the scope of acting for a proper purpose. Yet it is hard to conceive of a situation where the mere holding of an insignificant parcel of shares will enable a shareholder to act to the detriment of a company, other than in the fact that, by continuing to hold such a parcel, the company is denied the benefits that flow from any proposed reorganisation. In the case of *Sidebottom v Kershaw, Leese & Co*,[21] cited by the majority in *Gambotto*, it was held that the majority could expropriate the shares of a minority shareholder who was competing with the company.

What remains unclear is how the expropriation of the shares of such a person would remove the "detriment" of that individual competing with the company? Or, looked at a different way, just exactly how was that individual's ability to compete against the company improved by the fact that he held a small parcel of shares? It must be remembered that, almost by definition, in the expropriation cases, we are dealing with situations where the minority interest is insignificant.[22] Therefore, we must assume that in all such cases, it is unlikely that the minority shareholder would occupy a seat on the company's board or have the right to appoint a director, nor would it be likely that there are any other additional rights attached to the shares. Indeed, as will be argued below, in such cases, there is good reason to take an entirely different approach to the question of expropriation of such an interest.[23]

The foregoing comments all raise essentially practical problems with the reasoning of the majority. However, there is also a fundamental legal problem with the reasoning of both judgments. Having rejected the *Allen v Gold Reefs* test as inappropriate in the context of internal shareholder disputes (in my view correctly), both judgments apply a two-pronged test of whether the alteration of articles was for a proper purpose and whether or not it operated oppressively. I have already discussed the majority's view of what might or might not be proper purposes. I should point out that McHugh J did not impose any similar restriction. His reasoning is that the alteration of articles to permit an expropriation can be justified only if "the expropriation is necessary for the protection or promotion of the company's interests".[24]

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21 [1920] 1 Ch 154.

22 This is certainly going to be the case where the company concerned is a large public company. The situation may be different in the case of a closely-held proprietary company (as was the situation in *Sidebottom v Kershaw Leese and Co* [1920] 1 Ch 154, however, for reasons set out below, different considerations may well apply in any event in cases involving closely-held corporations. The basis on which the shareholder continuing to hold shares constituted a detriment in *Sidebottom* was that as a member of a small company, he would be able to exploit confidential business information relating to the company when carrying on a competitive business. It is hard to see how the mere fact of holding a small number of shares would give an individual any greater access to confidential business information than a member of the general public in all but those cases involving a closely-held corporation.

23 In the main, these cases will arise where the subject company's shares are closely held, although there is no reason in principle why such cases might not arise with respect to widely held public companies.

24 (1995) 182 CLR 432 at 453. Curiously enough, despite McHugh J having rejected the *Allen v Gold Reef* test of whether the alteration was "bona fide in the best interests of the company", this approach bears striking similarity to it.

The difficulty with this test is that it involves, somehow, a court inferring proper purposes in the context of a raw grant of power by the legislature. To be fair, McHugh J argues that the presence of an express power to expropriate in ss 701-703, leads him to the conclusion that the general power to alter articles in s 176 should be construed "as authorising the expropriation of shares only when it is necessary to do so in the interests of the company."[25] However, prior to so concluding, McHugh J makes in my view the critical error of improperly reversing an onus. Starting with a raw statutory grant of power in the form of s 176, McHugh J states that "Section 176 of the Corporations Law lacks any express or necessarily implied indication that the power to alter the articles of a company can be used generally for the purpose of enabling one shareholder to acquire the shares of another." To be perfectly fair, why should the section say anything at all about the purpose for which the power to alter the articles might be used. The legislature might have done so, but the statute contains no such language. Furthermore (and see further discussion of this point below), the statute does contain language attempting to restrict the scope of alterations to the corporate constitution in the form of s 180(3).

With respect, if McHugh J's approach to the interpretation of s 176 is appropriate, then one would have to conclude that ss 701-703 constitute a statutory code in respect of expropriation and that the power to alter articles to include a power to expropriate simply lies outside the scope of s 176. One would think there could be no middle ground. Furthermore, one would have to reach similar conclusions with respect to ss 195 (selective capital reductions) and 411 (arrangements). As a matter of policy, one would, in my view, have to conclude that, given the purpose of the takeovers code, ss 701-703 must be viewed in isolation and cannot be seen as implying any legislative view whatsoever on the question of the limitations applying generally to the power to alter a company's articles.

Even if one were to agree with either McHugh J's approach to statutory interpretation or the conclusions of the majority, the difficulty remains with regard to the nature of any limitation on the power to alter articles. The Corporations Law does contain one section that expressly limits the effect of alterations to the corporate constitution, and that section is s 180(3) which states:

> A member of a company, unless either before or after the alteration is made the member agrees in writing to be bound by it, is not bound by an alteration of the constitution made after the date on which the member became a member so far as the alteration:
>
> (a) requires the member to take or subscribe for more shares than the number held by the member at the date of the alteration;
>
> (b) in any way increases the member's liability as at the date of the alteration to contribute to the share capital of, or otherwise to pay money to, the company; or

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25 Ibid at 454.

(c) increases, or imposes, restrictions on the right to transfer the shares held by the member at the date of the alteration.

Given that the majority imply that, had the company's constitution contained a provision enabling the majority shareholder to expropriate Gambotto's shares from the outset, the case might have been decided differently,[26] it is hard to conceive of any basis on which the alteration can be made subject to a test of whether it was motivated by a "proper purpose". If one were to apply the same principles of statutory interpretation employed by McHugh J, then one would presumably conclude that s 180(3) is a code dealing with the question of the effect of alterations to the corporate constitution, leaving little or no room for judicial initiative. Furthermore, given the fact that s 180(3) deals expressly and exclusively with the very question at issue in this case, there is much more justification for so concluding.

In any event, both judgments express the view that the exercise by the majority of its power to alter articles is subject to a judicial determination of whether such power has been exercised for a proper purpose. The problem with such an implied limitation is that it is unclear on what basis any judge is competent to limit the wide grant of power. To be fair, at least McHugh J attempted to justify his conclusions by reference to the statute, but no such justification is contained in the majority judgment. The best expression of justification for the implied limitation in the majority judgment is contained in a quoted passage authored by Dixon J in *Peters' American Delicacy v Heath*,[27] which is worth repeating:

> The chief reason for denying an unlimited effect to widely expressed powers such as that of altering a company's articles is the fear or knowledge that an apparently regular exercise of the power may in truth be but a means of securing some personal or particular gain, whether pecuniary or otherwise, which does not fairly arise out of the subjects dealt with by the power and is outside and even inconsistent with the contemplated objects of the power.

However, the difficulty with this approach, attractive as it may seem, is that the statute which contains the grant of the power in question contains no express limitation on the use of the power. Furthermore, there is long-standing judicial authority to the effect that the individual shareholder's right to vote may be exercised in such manner as that shareholder pleases.[28] Simply put, "...the scope of an assigned power, whether

26 As witness the following passage: "The exercise of a power conferred by a company's constitution enabling the majority shareholders to expropriate the minority's shareholding for the purpose of aggrandizing the majority is valid if and only to the extent that the relevant provisions of the company's constitution so provide. The inclusion of such a power in a company's constitution at its incorporation is one thing. But it is another thing when a company's constitution is sought to be amended by an alteration of articles of association so as to confer upon the majority power to expropriate the shares of a minority." Ibid at 445.

27 Supra n 5 at 511-512, quoted in *Gambotto*, ibid at 443.

28 As Jessell M R stated in *Pender v Lushington* (1877), 6 Ch D 70 at 81: "[the shareholder] has a right to say "Whether I vote in the majority or minority, you shall record my vote, as that is a right of property belonging to my interest in this company, and if you refuse to record my vote I will institute legal proceedings against you to compel you."

assigned by statute or by delegation, is limited by the terms of its grant, not by abstract equitable principles."[29]

In a case such as that involving s 176, which contains the power to alter articles, the following passage, in my view, correctly summarizes the applicable principles.

> Where no particular purpose is stated, two possibilities are open. In some circumstances it may be possible to infer from the corporate constitution [or the statute] that the power has been given for some particular purpose, or at least for a type of purpose wholly unrelated to the purpose the corporate official had in mind. In other circumstances it may be impossible to infer a particular purpose by looking at the terms of the grant of power. It is the latter situation which has caused confusion in the past. The courts have, quite correctly, fallen back on the general equitable obligation to exercise all managerial powers in the best interests of the corporation. Unfortunately, courts have mishandled the next step. Judges have fallen into the trap of trying to define what is in the corporate interest. The results have not been satisfactory.[30]

Although this passage deals essentially with grants of power to managers contained in the corporate constitution, the same principles apply to the limitation of a statutory power granted to the majority of shareholders. The question remains: on what basis can or ought judges limit the scope of a power that is granted with no express limitations? As with the attempts to limit the scope of managers' powers, similar attempts in the context of the limitation of the power of the majority have been similarly unsuccessful and unsatisfactory.[31] As I have pointed out previously, the modern Australian statute contains a far more sensible means of balancing the interests of majority and minority in the form of s 260.[32] Given the fact that the Corporations Law now contains various provisions explicitly designed to afford a means of balancing the interests of majority and minority, it hardly seems necessary today to imply limitations on the power of the majority to achieve this purpose.

A final difficulty with the judgments, especially the joint judgment, is the reliance on the shareholder's proprietary rights as justification for the special approach taken to the expropriation cases. This, despite the fact that both judgments recognise the defeasible nature of the share as property.[33] The problem with the analysis based on the

29 B Welling, supra n 5 at 337.

30 Ibid.

31 For the very reasons given by the majority's rejection of the *Allen v Gold Reefs* test.

32 See S Fridman, "*WCP Ltd v Gambotto*: An Opportunity for the High Court to Set Some Corporate Law Norms" (1994) 22 *Fed L Rev* 205.

33 Per the majority: "...the courts have recognized that the proprietary rights attaching to shares are subject to modification, even destruction, by a special resolution altering the articles and that the power to vote is exercisable by a shareholder to his or her own advantage" (1995) 182 CLR 432 at 444. McHugh J's judgment recognises this by implication, as he concedes that, where the articles contain a pre-existing power to expropriate, the shareholder cannot legitimately complain of the act of expropriation unless it is effected in an oppressive fashion. I realise that it may be tempting for some readers to draw a distinction between cases where the power to expropriate is pre-existing and those where it is sought to be added by alteration of articles. However, in my view, this distinction is not relevant to consideration of the question of whether the share as property is defeasible. Either it is or it isn't. If it is by nature, then it is a separate question entirely whether any limitations should apply to the attempt to expropriate a shareholder's interest.

proprietary rights of the shareholder is that it essentially mandates a conclusion that expropriations are in principle unjustifiable. The following passage provides a useful and succinct statement of the effect of numerous American cases on point:

> The notion that certain rights of securities holders are "vested property rights" is superficially appealing and, as indicated in [*Bove v Community Hotel Corp of Newport, Rhode Island* 105 R I 36, 249 A 2d 89 (S C Rhode Island)], has been judicially adopted in a few instances. The effect of it, however, is to require unanimous consent for transactions, and that is usually impractical. Most modern corporation law commentators accept the idea that rights of securities holders may be modified over their individual objections by appropriate corporate action. Such modifications may be made only by following statutory procedures that give some protection to the shareholder: particularly the right to vote as a class in certain situations, the right to dissent and receive in cash a judicially determined "fair market value" in certain instances, and the requirement in many statue statutes that more than a majority vote is needed to approve certain proposals.[34]

When one considers the practical effect of the holding in *Gambotto*, the foregoing passage appears prophetic. If the problem, politically, in cases such as *Gambotto* is the striking of an appropriate balance between majority oppression and minority dictatorship, then the recognition of the property rights of individual shareholders as having primacy over any notion of corporate benefit effectively gives each individual shareholder, as indeed it did for Gambotto himself, a veto over certain forms of corporate reorganisation.

An Alternative View

If the High Court's approach to the resolution of the conflict presented by the facts in *Gambotto* is flawed, is there a better view? To my mind there is an alternative way of looking at the issues and of resolving the conflict between minority and majority presented by the expropriation cases. That view rests on recognition of the defeasible nature of the property represented by the share and the direct consideration of what rights the shareholder possesses that ought not be subject to destruction by appropriate means. In this portion of the chapter, I intend to suggest some broad principles which might more effectively govern the determination of conflict over expropriation of shares.

Shares as property

It is trite to state that a share is a form of property. However, more importantly is the consideration of what form of property it is. It is, simply put, a chose in action. A share represents a bundle of rights granted to the holder. In this sense, a share is analogous to other choses in action, such as rights in a contract. Indeed, given the contractarian nature of Australia's corporate law, this analogy seems very appropriate.

A share then is different to a tangible item of property and is more closely related to other choses in action such as the right to receive performance of a contractual promise.

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34 R W Hamilton, *Cases and Materials on Corporations* (5th ed, West Publishing Co, 1994) at 1249.

Therefore, when considering the conditions under which such property might be expropriated, it makes some sense to consider the manner in which the property represented by contractual rights is protected.

Consider the following example. I promise to sell my computer to Jill for $2000 and promise to complete the sale on Thursday. Thursday arrives and I refuse to part with my computer. Jill insists that I do so. I have, in effect, denied Jill her contractual right. In effect, I have taken her property from her. The legal conclusion is that I have acted in breach of contract, for which, assuming that Jill can prove the existence of the contract, the fact of my breach, and I am unable to assert any valid defence, I will be legally responsible.

Can Jill insist on my transfering my computer to her? The answer is, only if she can prove that damages would be inadequate, as the remedy of right for breach of contract is damages, not specific performance. Whether Jill is able to compel me to part with my computer will turn on whether she is able to demonstrate that there is something unique about it, such that damages would be incapable of providing her with compensation for her lost expectation.

Not only does this rule make common sense, it is also economically efficient. Where there exists a ready market substitute for the property in question, the law requires the innocent party to mitigate her loss and go out into the market to obtain the substitute. The contract breaker will be liable for any increased cost borne by the innocent party. I am of course ignoring for present purposes the important moral question of whether or not the law should encourage parties to stick to their bargain, regardless of whether or not it is "efficient" to break it.[35] For present purposes, the moral question presented is simply irrelevant.

Now, let us apply the same principles to the expropriation of shares. If we assume that the individual shareholder's rights include the right to hold the share (as indeed we must, and as the judgments in *Gambotto* assert) then the effect of the expropriation is to deny the holder of a chose in action the ability to enjoy the rights represented by it. When the individual shareholder asserts his or her right to continue to hold the share, he or she is in effect saying "I want specific performance of my contract". In other words, especially in the case of expropriation, implicit in the objection is the view that either the price being offered is not a fair one or that it is somehow insufficient to compensate the shareholder for what he or she has lost.

If the share is recognised as an item of property capable of being valued objectively, this conflict is relatively easy to resolve. The shareholder can be properly compensated by payment of the appropriate amount of money. On the other hand, if the share is not so recognised, then compensation will be difficult to determine.

35 See generally, C Fried, *Contract As Promise* (Harvard University Press, 1981) and also R MacNeil, "Efficient Breach of Contract: Circles in the Sky" (1982) 68 *Virginia LRev* 948.

Does this way of looking at the problem not seem very similar to the means adopted by our courts of resolving when and when not to order specific performance of a contract? If it does, the answer is explainable in economic terms. In cases where the subject matter of the contract is unique, the courts are unable to value the property on account of the consumer surplus problem. In layman's terms, the problem is that the innocent party places a value on the property that a third party cannot assess objectively and which is different from the market value of the property, if there is one. Accordingly, it is virtually impossible in such cases to calculate damages, and hence the order for specific performance.

How might this apply to the situation involving company shares? Simply put, where the shares are a minute parcel, conferring no rights of control, positive or negative, and further carry no special rights, such as the right to appoint a director or the right to employment with the company, there would seem little reason indeed to treat the share as anything other than a "capitalised dividend stream" or an undivided interest in the net asset value of the company. Either way, the value of the share is easily capable of being determined objectively and the only issue relating to the expropriation ought be whether or not the price paid is a fair one.[36]

This approach is implicitly recognised by those jurisdictions which have chosen to include an appraisal remedy in their corporate statutes.[37] In effect, such a remedy is a statutory version of the above, as the way it works is that the individual shareholder can insist on being bought out at "fair value" on the happening of certain events. In all cases, one of those events is the amendment of the company's articles of association. The statutory appraisal remedies normally provide a code for the determination of fair value if the shareholder and the company or the majority are unable to agree on one.

To the extent that one takes the view that share ownership ought be given some value and not disturbed lightly, might I suggest that McHugh J's judgment contains the essence of what might be regarded as an appropriate test. If the majority can demonstrate that the expropriation will operate to provide a benefit for the company, then there ought be no reason to set it aside, unless it can be demonstrated that the interest of the minority is not susceptible to objective valuation. While agreeing generally with the approach taken by McHugh J, given what I have said above concerning judicial review

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36 This underlying view is implicit in the following statement of Bryson J, taken from his judgment in *Nicron Resources Ltd v Catto* (1992) 10 ACLC 1186 at 1193, concerning judicial review of a selective reduction of capital designed to expropriate minority shareholders:

> [T]he Courts act on the basis that it is enough if the reduction is fair and equitable to all concerned: they do not act on the basis that the extinguishment of shareholdings can or should only take place by consent, or that extinguishment is unfair *per se*. The Courts appear to me to have equated payment of the fair equivalent in money of the value of shares with fair and equitable treatment....[if a minority shareholder] is expelled with a cheque for a fair sum, his feelings of attachment to his property and his decision to invest in it and his wish to continue with the investment are not the test of fairness.

37 See for example, Ontario Business Corporations Act s 185.

of the exercise of majority voting power,[38] there is little basis on which to add any limitation concerning the question of benefit to the company. To the extent that any expropriation should not proceed unless the interests of the minority are adequately provided for, the most appropriate solution would appear to be the mandating of approval by a majority of disinterested shareholders.[39]

Ultimately, then, the question ought boil down to whether the shareholder's investment is capable of objective valuation by a third party.[40] Aside from making inherent common sense, there is much else to commend this solution. In the first place, it is efficient. Shares, like any other form of property, will be capable of such valuation where there exists a ready market or a ready substitute. There will of course be cases where a shareholder might assert that the shares hold a special value to him or her, but it is likely that these cases will be rare.[41] Perhaps the most important result of taking this approach would be to reduce opportunities for greenmailing.[42] Additionally, a rule of this type would almost certainly reduce the transactions costs of reorganisation by avoiding the need to negotiate separate bargains with individual shareholders. Finally, such a rule would be consistent with the policy of equal sharing among shareholders, as all would be given the same price for their shares, rather than some being able to

38 See the discussion at notes 5 and 7 above.

39 Sometimes referred to as approval by the "majority of the minority". This is the approach taken in the provisions of the Ontario Business Corporations Act s 190(4). The Australian Securities Commission has recommended a similar restriction on voting in respect of selective reductions of capital: see Practice Note 29: Selective Capital Reductions, ASC Releases PN 29, 20 January, 1993.

40 I will not in this chapter concern myself with the various methods of valuation currently in use. Suffice to say that there are numerous alternatives currently in use and any review of statutory appraisal remedies can provide examples of means to adjudicate disputes between majority and minority concerning the question of valuation: see for example Ontario Business Corporations Act s 185.

41 One of the compelling questions arising from the *Gambotto* case, of course, is what exactly motivated Mr Gambotto to pursue his appeal all the way to the High Court. That question has never effectively been answered. It might be seen by some as prima facie evidence that Gambotto placed a special (and presumably high) value on his small parcel of shares. However, it is suggested that mere objection to a compulsory acquisition cannot be taken as evidence in and of itself of special value. There are cases where Courts have supported an individual's efforts to retain shares, despite the fact that the individual has been offered a fair price. One such case is *Baburin v Baburin* (1990) 2 Qd R 101, concerning an application to set aside the sale of shares on the basis of unconscionability. The Court held that provision of fair value for the shares would not prevent the sale from being set aside if the unconscionability could be proven. Of course, this case was not one involving a compulsory acquisition and it may well be argued that different considerations entirely operate in the context of an attempt to rescind a consensual transaction on this basis.

42 This is a controversial point. Arguably, preferring the individual shareholder's "right" to hold shares over the voice of the majority shareholder presents skilled or fortunate investors with opportunities to acquire strategic stakes in companies desiring to reorganise (as in the Goldfields takeover of Pancontinental Mining where QBE Insurance purchased a blocking stake of 10.2% thus frustrating Goldfields' ability to invoke the s 701 in order to obtain the desired 100% ownership: see "Pancon Cleanup Gets Messy" *Australian Financial Review*, 7 August 1995 at 52). Whether such investors are to be excoriated as "greenmailers" or regarded as having earned the right to exploit their strategic shareholding is a matter for debate.

secure a higher price should they succeed in holding out and placing themselves in a strategically advantageous position.[43]

The protection of entitlement

Another way of looking at the problem is to focus on the question of how best to protect an "entitlement". To use the words of Calabresi and Melamed:

> Whenever a state is presented with the conflicting interests of two or more people, or two or more groups of people, it must decide which side to favor ...The state not only has to decide whom to entitle, but it must also simultaneously make a series of equally difficult second order decisions. These decisions go to the manner in which entitlements are protected and to whether an individual is allowed to sell or trade the entitlement. In any given dispute, for example, the state must decide not only which side wins but also the kind of protection to grant...entitlements [may be] protected by property rules,...liability rules, and [there may be] inalienable entitlements.
>
> ...An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller.
>
> ...Whenever someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it, an entitlement is protected by a liability rule. This value may be what it is thought the original holder of the entitlement would have sold it for. But the holder's complaint that he would have demanded more will not avail him once the objectively determined value is set.
>
> ...An entitlement is inalienable to the extent that its transfer is not permitted between a willing buyer and a willing seller. The state intervenes not only to determine who is initially entitled and to determine the compensation that must be paid if the intitlement is taken or destroyed, but also to forbid its sale under some or all circumstances.[44]

This analysis is illuminating, as there is certainly no question as to the individual shareholder's right to hold shares. The essential question that arises in the compulsory acquisition cases is by what means that entitlement ought be protected. A property rule would permit the individual shareholder to refuse to transfer the shares for any reason, whether based on inadequacy of compensation or not. A liability rule would focus on the issue of whether value could be objectively determined. If it could, then so long as the shareholder is provided with that value as a minimum, then he or she would be unable to resist the transfer. A rule of inalienability would forbid the transfer at all events. An example of circumstances where this might be the case would be an

43 This policy is consistent with one of the primary goals of takeover legislation and applies similarly in the context of a reorganisation or "going private transaction" (see below).

44 G Calabresi and A D Melamed, "Property Rules, Liability Rules and Inalienability: One View of the Cathedral" (1972) 85 *Harv LRev* 1089 at 1089-1091.

acquisition that offended the provisions of Part IV of the Trade Practices Act 1974 (Cth).

If we assume that, aside from cases involving breach of s 50 of the Trade Practices Act, there are no good reasons to prohibit transfers of shares, then the choice of method of protection of the shareholder's entitlement becomes one of property rule or liability rule. *Gambotto* results in essentially a property rule. By limiting the circumstances under which the majority can force the minority to part with shares, the High Court has effectively mandated a regime where the majority shareholder must negotiate individually with each dissenting shareholder. Absent agreement on terms affecting the acquisition of shares, the individual shareholder will retain his or her investment.

The alternative would be a form of liability rule, where the transfer would take place at an objectively determined fair price. From an economic perspective, the circumstances which favour a liability rule are those where collective valuation of the entitlement is more efficient than individual valuation, transactions costs are likely to be high for individual transactions and there is a potential holdout problem.[45] These considerations again turn on the question of objective valuation. Once it is conceded that this is possible, then there would appear to be little doubt that, from the perspective of economic efficiency, a liability rule is to be preferred.

To the extent the foregoing is correct, then the focus in cases of compulsory acquisition ought be on value, rather than justification. Given the strategic advantage enjoyed by the acquirer,[46] the question of disclosure becomes crucial.[47] Other than the strategic advantage enjoyed by the majority, there is the question of access to information concerning value. One commentator has characterised this as "a risk of an unfair appropriation of hidden values in the enterprise by majority shareholders."[48] This

45 Ibid at 1106-1115

46 McHugh J made this point well when he stated, in respect of using current market price as a prima facie indication of fair value: "Sharemarkets are driven by many factors, not all of them rational or fair. Even the share prices of long established and profitable companies may fluctuate by as much as 50% in the space of a year. A share is an interest, however small, in an underlying business. Outside the context of the stockmarket, it would not occur to the owner of a business to think that the fair value of his or her business could move up and down, sometimes violently, not only from week to week or day to day but during the course of a day. No doubt in the long term the share price of a company will reflect its fundamental earning capacity or value. But the histories of stockmarkets are overrun by examples of companies whose intrinsic value remained unnoticed by the market for long periods of time...Wynn-Parry J asserted in *Re Press Caps Ltd* [1949] Ch 434 at 447 that "the final test of what is the value of a thing is what it will fetch if sold". But what it will fetch depends on when it is sold. Shareholders whose shares are expropriated have no say concerning the timing of the expropriation." *Gambotto*, supra n 8 458.

47 See chapter 3.

48 See P Spender, "Compulsory Acquisition of Minority Shareholdings" (1993) 11 *C & SLJ* 83 at 91. For those who prefer a more technical description of the problem: "The risks of opportunistic redistribution are heightened due to asymmetric possession of information regarding company value. The majority shareholders or managers may possess inside information disclosing hidden values that are not reflected in the market price of the company's securities and may wish to capture these values for themselves by excluding the minority." J G MacIntosh, "The Shareholders' Right of Appraisal in Canada: A Critical Reappraisal" (1987) 24 *Osgoode Hall LJ* 201 at 229.

problem, too, can essentially be solved by mandating adequate disclosure.

Approval of the transaction

I have already ventured my opinion of the imposition of judicially determined norms for corporate behaviour. Simply put, there is neither statutory nor principled justification for imposing a requirement that the expropriation be, in the opinion of a judge, for the benefit of the company (however one defines benefit). Despite this, and despite the High Court's rejection of the test of "bona fide for the benefit of the company as a whole" as inappropriate in the context of internal corporate disputes, there may still be good reason to protect the interests of minority shareholders by ensuring that a requisite proportion of their number approve of the transaction. We should bear in mind that this requirement, even if it involves disenfranchising the majority for this purpose, falls some distance short of protection by means of a property rule.

At the outset, it is worth noting that nothing presently in the Corporations Law precludes any shareholder from voting on the question of expropriation. Despite this, it is generally regarded as prudent practice for the majority shareholder, or proponent of the scheme, to abstain from voting.[49]

Can the common law solve the problem?

Given the failure of courts to prescribe workable rules for resolving minority-majority conflicts to this point, it seems unlikely that the High Court's recent attempt in *Gambotto* will meet with any greater success. For one thing, even the conditions prescribed in *Gambotto* do not address the question of majority abstention from voting. Furthermore, despite McHugh J focussing on the questions of price and disclosure, there is still little technical guidance on either question.

One approach would be to wait and see how courts and the corporate community accommodate the *Gambotto* decision and evaluate its effect over time. Unfortunately, however, we have already seen *Gambotto* advanced as justification for the abandonment of at least one significant corporate transaction.[50] Furthermore, the insistence of the High Court on the idea of providing some justification based on corporate good for the expropriation may prove problematic and may further involve a return to the difficulties encountered with the old *Allen v Gold Reefs* test. This problem could be avoided by the creation of an appropriate statutory code. We have already seen the move toward statutory provisions as a means of protecting the interests of the minority (in the form of s 260). Given the number of technical issues on which solicitors and other corporate

49 As indeed was the case in *Gambotto*. This practice has been recommended by the ASC in the context of selective reductions of capital: see Practice Note 29, supra n 39.

50 In the aftermath of the NRMA's decision to abandon the idea of demutualisation, a number of commentators picked up on statements to the effect that the board of NRMA felt that the *Gambotto* decision evidenced a trend toward favouring minority interests that mitigated against proceeding with the transaction. Interestingly enough, to the extent this view was actually held by the directors, it was based, in my view, on a misapplication of the ruling in *Gambotto*, as the demutualisation of NRMA could not, in any way, be characterised as an expropriation of minority interests. See also chapter 4 on this point.

advisors will require guidance (such as disclosure, appropriate voting arrangements and resolution of disputes relating to valuation), the statutory approach is to be preferred. This might also result in the standardisation of procedure in cases of expropriation.

A suggested statutory approach

At present the only detailed code providing for compulsory acquisition of shares of the minority appears in the takeovers code (Chapter 6, Corporations Law) in the form of ss 701-703. In circumstances where a formal takeover bid under Chapter 6 is either not required or possible, there is an alternative procedure available under s 414. However, s 414 contains no requirement for court approval or a meeting of shareholders, nor does it include mandatory statutory disclosure requirements.[51] The other commonly used alternative methods of squeezing out minority shareholders are subject to even less regulatory control.[52]

One question that occurs is whether there is any good reason for the fact that the only detailed compulsory acquisition scheme is contained in the takeovers code. One possible reason is that it may be felt that the disclosure provided in the form of the Part A statement is necessary for the protection of the minority. This necessity could however easily be addressed in the form of appropriate disclosure requirements contained in a compulsory acquisition code.[53]

One might also ask whether there is anything unique about the takeover mechanism that, at least as far as express authority in the Corporations Law is concerned, is the only form of transaction containing a compulsory acquisition power. If we look at the justification advanced for the original insertion of a compulsory acquisition power into the English Companies Act, 1928, what is apparent is that that justification might equally apply to other forms of corporate reorganisation. The following was contained in the report of the Greene Committee:[54]

> The acquiring company generally desires to obtain the whole of the share capital of the company which is being taken over and in some cases will not entertain the business except on that basis. It has been represented to us that holders of a small number of shares of the company which is being taken over (either from a desire to exact better terms than their fellow shareholders are content to accept or from lack of real interest in the matter) frequently fail to come into an arrangement which commends itself to the vast majority of their fellow shareholders with the result that the transaction fails to materialize. In our opinion this position - which is in effect an oppression of the majority by a minority - should be met.

The foregoing is premised on the implicit notion that the takeover in question is a transaction that ought proceed (for whatever reason), and that therefore the acquirer's

51 See the CASAC Report, supra n 3.

52 Ibid. See also chapter 2.

53 As with the OBCA s 190(2) and (3).

54 Cmd 2657(1926) para 84.

desire to own 100% of the share capital ought to be facilitated. But is there anything unique about a takeover in that the power to acquire dissenting shares by compulsion ought be dependent on utilising the complex and expensive procedures solely available in the context of a takeover?[55]

In this respect, what is required is a statutory code for compulsory acquisitions. It is submitted that the provisions of the Ontario Business Corporations Act provide a reasonable model from which to craft a suitable Australian variant. In addition to the now standard power to expropriate granted to a bidder who acquires 90% or more of the relevant securities of the company, these provisions also apply to what is termed a "going private transaction".[56] Such a transaction is defined in the OBCA as:

> an amalgamation, arrangement, consolidation or other transaction carried out under this Act by a corporation that would cause the interest of a holder of a participating security of the corporation to be terminated without the consent of the holder and without the substitution therefor of an interest of equivalent value in a participating security that,
>
> (a) is issued by the corporation, an affiliate of the corporation or a successor body corporate, and
>
> (b) is not limited in the extent of its participation in earnings to any greater extent than the participating security for which it is substituted...

The provision then mandates that a valuation shall be prepared by an independent, qualified valuer including a security value or range of values for each class of affected securities.[57] Furthermore, the statute requires the corporation to send a management information circuler to the holders of affected securities within forty days of the meeting called to consider the transaction.[58] Finally, the statute prescribes the appropriate approvals to be obtained. Where consideration offered is payable in whole or in part other than in cash, the approval must be by special resolution.[59] In other cases, the approval need only be by ordinary resolution.[60] In all cases, the votes of interested

55 I am not forgetful of alternative mechanisms by which a compulsory acquisition might be achieved, as canvassed in chapter 2.

56 OBCA s 190.

57 OBCA s 190(2). In addition the valuation must be no more than 120 days before the announcement of the transaction and contain appropriate adjustments for subsequent events after the going private transaction. This would address one of the criticisms made of the *Gambotto* decision (that the judgments in the High Court did not take account of the increase in value to the company consequent on the completion of the compulsory acquisition): see comment in (1995) 13 *C & S LJ* 326 at 328. In addition to the foregoing, other matters addressed in the OBCA provision dealing with valuation require that the valuation shall contain no downward adjustment to reflect the fact that the shares to be acquired do not form part of a controlling interest and further that, where the consideration offered consists of elements other than cash, the valuer shall provide an opinion as to whether the value of the shares to be surrendered is equal to or greater than the total consideration to be received therefor.

58 Ibid s 190(3).

59 Ibid s 190(4)(1).

60 Ibid s 190(4)(2).

shareholders will be disregarded.[61] The Ontario Securities Commission is given the power to exempt any person from any of the foregoing requirements where "in its opinion to do so would not be prejudicial to the public interest".[62]

What seems clear, on review of the Ontario provisions, is that the statute has been designed to provide a code for both majority shareholders who wish to consolidate their ownership and also for minority shareholders who wish to assert their rights. The balance between the rights of minority and majority appears to have been struck, based on the provision of appropriate disclosure and the requirement, in most cases, of approval by the majority of the minority. A critical supplement to the going private transaction provisions is the statutory appraisal remedy contained in the Ontario legislation. Of interest is that the going private transaction provisions do not require any minimum level of majority ownership, nor is there any attempt made in the statute to restrict the circumstances in which the majority might proceed. It is submitted that this approach is one that ought be considered in Australia.

Conclusion

In this chapter I have attempted to illustrate how the *Gambotto* case raises more questions than it answers. By preferring the "proprietary rights" of minority shareholders, the High Court has potentially created an environment where minority dictatorship might prevail. While some have opined that we must wait and see how the business community and the courts respond to *Gambotto*, I submit that it is almost inevitable that statutory reform will be required. The provisions of the Ontario Business Corporations Act provide at the very least a useful starting point for that process of reform.

61 Ibid s 190(4)(3). In other words, the approval must be by a "majority of the minority".

62 Ibid s 190(6). The Ontario Securities Commission (OSC) has published detailed guidelines concerning the operation of the going private transactions provisions in the form of OSC Policy Statement 9.1. This Policy Statement, like ASC Practice Directions, does not have force of law. However, it contains detailed and useful information concerning the practical operation of the statutory provisions, and the approach the OSC takes to the application of its discretion. The Policy Statement is detailed and a full description of its contents is beyond the scope of this chapter. However, the following, taken from para 20(2) dealing with minority approval, provides a useful example of the sort of circumstance where an exemption will be granted:

> If a person or company already is the holder of 90% or more of each class of voting securities of the issuer at the time the related party transaction is initiated, the requirement for minority approval will not apply to the transaction if a statutory appraisal remedy is available to the minority security holders or if a substantially equivalent enforceable right is made available to the minority security holders.