Master of Law
Minor thesis

How section 667C of the Corporations Act should be interpreted and its application to the various forms of compulsory acquisition

Allan Bulman

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Synopsis

Two of the innovations arising from the *Corporate Law Economic Reform Program Act 1999* were a new compulsory acquisition power and a statutory definition of fair value in s667C of the *Corporations Act*. Section 667C has brought to the forefront issues of fairness and valuation of consideration offered under compulsory acquisition.

This paper commences by considering the legislative background behind the new compulsory acquisition power in Part 6A.2 of the *Corporations Act* and s667C. There is a discussion about the various terminology used in valuing securities and an examination of the major valuation methodologies. There is consideration of the question as to how securities should be valued from a policy point of view for the purposes of compulsory acquisition. To assist in determining this policy question and in considering the application of s667C there is an analysis of valuation cases from the Supreme Court of Delaware.

There is also a consideration as to how s667C should be interpreted and an examination of the cases that have so far considered this provision in detail. In considering these cases, there is a particular consideration as to whether 'special benefits' should be included in determining fair value under s667C.

The paper concludes by considering the 'gravitational pull' of s667C on forms of compulsory acquisition other than Part 6A.2. There is a likelihood that s667C has a broad application to various forms of compulsory acquisition under the *Corporations Act* which may provide added protection to minority security holders.

This paper reflects the law as at 1 May 2002.

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While the author is an employee of the Australian Securities and Investments Commission, the views expressed in this paper are the views of the author alone.

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1. Introduction

The High Court's decision in *Gambotto v W.C.P. Limited*[1] ('*Gambotto*') not only significantly curtailed the ability of companies to acquire compulsorily shares by way of seeking an amendment to their constitutions, but also provoked considerable debate into the policy underlying compulsory acquisition of securities generally.[2] In considering the various forms of compulsory acquisition of securities prior to the commencement of the *Corporate Law Economic Reform Program Act 1999* ('*CLERP Act*'), Boros made the insightful comment that there were conflicting policies reflected in the various methods of compulsory acquisition.[3] In particular Boros noted:

- That the requirement for a 'total entitlement' test to compulsory acquisition following a bid, which ignores the bidder's entitlement to voting shares prior to the bid, conflicts with 'one of the key justifications for the compulsory acquisition power' being 'the acceptance of the offer by a high proportion of the issued capital'.
- The 'plethora of compulsory acquisition' methods, some of which have thresholds based on the number of acceptances while others have varying thresholds depending on votes cast at shareholder meetings.[4]

In response, at the very least in part to the decision in *Gambotto*, the *CLERP Act* introduced a number of reforms to compulsory acquisition, including the introduction of a new compulsory acquisition power in Part 6A.2 of the *Corporations Act 2001 (Cth)* ('*Corporations Act*').[5] In summary, Part 6A.2 allows a '90% holder' to commence the compulsory acquisition of securities[6] in a class by serving a compulsory acquisition

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[1] (1995) 182 CLR 432.
[2] Note for example the various articles in Ian M Ramsay (ed), *Gambotto v WCP Ltd: Its Implications for Corporate Regulation* (1996). For a useful summary of the reactions to *Gambotto v W.C.P. Limited* see Peta Spender, 'Guns and Greenmail: Fear and Loathing After Gambotto' (1998) 22 *Melbourne University Law Review* 96 and Helen Bird, 'A Critique of the Proprietary Nature of Share Rights in Australian Publicly Listed Corporations' (1998) 22 *Melbourne University Law Review* 131.
[3] Elizabeth Boros, 'Compulsory Acquisition of Minority Shareholdings – The Way Forward?' (1998) 16 *Company and Securities Law Journal* 279, 292
[4] Ibid.
[5] The *Corporations Act* replaced the *Corporations Law* on 15 July 2001 as a solution to the constitutional difficulties inherent the *Corporations Law*. The provisions of Chapters 6, 6A, 6B and 6C are identical in the *Corporations Act* as they were in the *Corporations Law* in force immediately prior to 15 July 2001.
[6] This paper relates to the compulsory acquisition of securities generally. Therefore the terms 'securities' and 'security holders' will be used unless there is a requirement to be more specific. For example, a

notice and an independent expert's report on the minority security holders. Compulsory acquisition of the minority will occur if:

- no minority security holders object to the acquisition;
- in the case where minority security holders object to the acquisition, they represent less than 10% of the value of the remaining securities in the class at the end of the objection period; or
- the Court[7] approves the transaction.[8]

For the purposes of the new compulsory acquisition power in Part 6A.2, the Court must approve the compulsory acquisition if the majority holder 'establishes that the terms set out in the compulsory acquisition notice give a fair value for the securities.'[9] Another innovation introduced by the *CLERP Act* is a statutory definition of fair value. Fair value, for the purposes of both Part 6A.2 and the Court's consideration of compulsory acquisition following a takeover,[10] is defined in s667C(1):

> To determine what is fair value for securities for the purpose of this Chapter [6A]:
>
> (a) first, assess the value of the company as a whole; and
> (b) then allocate that value among the classes of issued securities in the company (taking into account the relative financial risk, and voting and distribution rights, of the classes); and
> (c) then allocate the value of each class pro rata among the securities in that class (without allowing a premium or applying a discount for particular securities in that class).

Chapter 2 of this paper considers the legislative background behind Part 6A.2 and s667 and the requirements of Part 6A.2 in greater detail.

Observers of the *CLERP Act* changes could be forgiven if they concluded that Part 6A.2 and s667C have added to Boros's conflicting policies. For a start, there is no requirement

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particular situation or case may relate only to options or the provisions of another jurisdiction may relate solely to shares. For the purposes of this paper, references to voting shares are taken to include voting interests in listed managed investment schemes.

[7] 'Court' for the purposes of Chapter 6A is defined in s58AA(1) of the *Corporations Act*. The majority of cases under Chapter 6A will be before either a state Supreme Court or the Federal Court.

[8] Subsection 664A(3) of the *Corporations Act*.

[9] Subsection 664F(3) of the *Corporations Act*.

[10] Subsection 661E(2) of the *Corporations Act*.

for any positive assent of the minority security holders in Part 6A.2. Other forms of compulsory acquisition in the *Corporations Act* rely wholly or in part on the affirmative assent of the minority security holders. For example the following is a summary of the various hurdles relating to the various forms of compulsory acquisition which reflect these conflicting policies:

- **A selective capital reduction** which involves the cancellation of shares requires the additional approval of 'a special resolution passed at a meeting of the shareholders whose shares are to be cancelled.'[11]
- **A scheme of arrangement** must be approved by 75% of each relevant class of shares or debts.[12] In relation to members, the scheme must also be approved by the majority of members. The majority shareholder or optionholder would constitute a separate class for the purposes of compulsorily acquiring a minority by way of a scheme.[13] Schemes are also subject to an approval process by the Court.[14]
- **Compulsory acquisition following a takeover** requires the bidder and its associates to have a relevant interest in 90% of the securities in the bid class and to have acquired 75% in number of the securities 'that the bidder offered to acquire under the bid'.[15]
- **Compulsory acquisition under s414** requires the approval of 'members holding shares in that class carrying at least 90% of the votes attached to shares in that class' and in most cases approval by 75% of those members by number.[16]
- **Compulsory acquisition by means of an amendment to a company's constitution** requires approval by special resolution under subsection 136(2) of the *Corporations Act*. The majority of the High Court in *Gambotto* (Mason CJ, Brennan J, Deane J and Dawson J) stated that this power could only be used for a proper purpose and where its exercise 'will not operate oppressively in relation to minority shareholders'.[17] The majority of the High Court left open the question of whether the remaining shareholder could vote for the resolution.[18]
- **Arrangements by a liquidator to accept shares as consideration for the sale of company property** must be approved by a special resolution of the company.[19]

Prior to the *CLERP Act* changes, there was uncertainty as to whether the issue of fairness in consideration was a determining factor in a Court's discretion to approve or overturn compulsory acquisition, whether by means of takeover, capital reduction, scheme or other

[11] Subsection 256C(2) of the *Corporations Act*.
[12] Subsection 411(4) of the *Corporations Act*. Optionholders are creditors for the purposes of the scheme provisions, *Re US Masters Ltd* (1991) 4 ACSR 462, 464.
[13] *Re Jax Marine Ltd and Companies Act* (1966) 85 WN (Pt. 1) (NSW) 130.
[14] See s411(1) and s411(4) of the *Corporations Act*.
[15] Subsection 661A(1) of the *Corporations Act*. Prior to the commencement of the *CLERP Act* the relevant provision was s701 of the *Corporations Law*.
[16] Subsections 414(2) and 414(5) of the *Corporations Act*.
[17] (1995) 182 CLR 432, 445.
[18] Ibid 444.
[19] Subsection 507 of the *Corporations Act*.

provision. The issues of fairness and valuation of consideration have now been brought to the forefront as a result of the introduction of s667C.

The valuation of securities for the purposes of compulsory acquisition is a complex issue, which has only been considered in depth by Australian courts in a handful of cases. For a start there is an issue of terminology. There are various expressions such as ‘fair value’, ‘control premium’, ‘minority discount’, ‘synergies’ and ‘special benefits’, which are referred to in compulsory acquisition cases and in commentaries. The interrelationship between these expressions is not always clear. Is the term ‘control premium’ the direct converse of ‘minority discount’ or does it include some ‘synergies’? What is the difference between ‘special value’ and ‘special benefits’? Does the expression ‘special benefits’ mean the same thing as ‘synergies’? Should ‘fair value’ include a ‘minority discount’, ‘control premium’, ‘synergies’ or ‘special value’?

What is even more confusing is that some valuation methodologies have an implicit ‘minority discount’, some exclude a ‘minority discount’ and some may well include some level of ‘synergies’ and ‘special benefits’. A Court needs to understand the affect of particular valuation methodologies in determining fair value. Chapter 3 of this paper considers the terminology commonly used in valuing securities and the main valuation methodologies. This Chapter will also consider case law and scholarship, predominately from Australia and the United States, in considering from a policy point of view what should be included in valuing securities for the purposes of compulsory acquisition. In particular this section will consider whether a ‘minority discount’, ‘synergies’ and ‘special value’ should be taken into account in valuing securities for the purposes of compulsory acquisition. This Chapter will conclude by considering how the courts in Delaware deal with the issues arising from the valuation of securities for the purposes of compulsory acquisition and how the courts in Delaware deal with minority discounts and synergies. Cases from Delaware provide useful examples of the policy issues discussed in this Chapter. The decisions by Delaware courts and the learning from American commentators are also useful for Australian Courts in interpreting s667C and for policy makers in determining how securities should be valued for the purposes of compulsory acquisition.

Chapter 4 of this paper will consider how s667C should be interpreted, taking into account the legislative history of the provision explored in Chapter 2. To a great extent the most natural reading of s667C accords with the policy conclusions detailed in Chapter 3. Included will be a detailed analysis of the first five Australian cases which have considered s667 in detail: *Winpar v Goldfields Kalgoorlie* and *Winpar v Goldfields*[20] ('*Goldfields Kalgoorlie 1 & 2*'), *Pauls v Dwyer & Ors*[21] ('*Pauls2*'), *Re Goodyear Australia Limited; Kelly-Springfield Australia Pty Ltd v Green and Ors*[22] ('*Kelly-Springfield*') and *Capricorn Diamonds Investments Limited v Robert John Catto & Ors*[23] ('*Capricorn Diamonds*').

This Chapter will also consider the discussion in recent Court cases of the potential application of the requirement in s51(xxxi) of the *Australian Constitution* that compulsory acquisition by the Commonwealth is required to be on just terms.

Boros, in considering the proposed introduction of Part 6A.2 and s667C, expressed the concern that the new compulsory acquisition power, which is not based on the affirmative assent of the minority, represented 'a shift in the policy currently underlying compulsory acquisitions to the detriment of the interests of the minority shareholders'.[24] Chapter 5 of this paper considers the affect of s667C on the various provisions in the *Corporations Act* relating to the compulsory acquisition of securities. This issue is also not without its share of complexity.

There is again confusion over terminology. Part 6A.2 requires the Court to approve the acquisition where the 90% holder 'establishes that the terms set out in the compulsory

[20] (2000) 34 ACSR 737 and (2001) 40 ACSR 221.
[21] (2001) 19 ACLC 959.
[22] [2002] NSWSC 53.
[23] [2002] VSC 105.
[24] Elizabeth Boros, above n 3, 291.

acquisition notice give **a fair value** for the securities.'[25] For challenges to compulsory acquisition following a takeover, a Court may only order that the securities in question not be acquired if 'the Court is satisfied that the consideration is not **fair value** for the securities.' It is clear that fair value in these two cases is defined in s667C(1) as the section is expressed to apply to Chapter 6A.

However the application of s667C(1) to other statements relating to fairness of consideration in the *Corporations Act* generally is less than clear. Subsection 256B(1) provides that a company may undertake a capital reduction if, amongst other matters, it '**is fair and reasonable to the company's shareholders as a whole**'. Section 640 provides that where an expert's report is required to be prepared by the target in a takeover under that subsection, that the report must state 'whether, in the expert's opinion, the takeover offers are **fair and reasonable**.' In relation to situations where an expert's report is required for a scheme of arrangement, the expert is required to state 'whether or not, in his or her opinion, the proposed Scheme is in the **best interest of the members of the company** the subject of the Scheme and setting out his or her reasons for that opinion'.[26]

It is unclear to what extent should the principles in s667(1) be applied to these varied phrases. It is also unclear to what extent ASIC's Policy Statement 75, which outlines ASIC's view on the meaning of 'fair and reasonable' for the purposes of s640, impacts on other similar phrases.[27]

Santow J in *Goldfields Kalgoorlie1* considered s667C(1) in the context of a capital reduction. One conclusion that arose out of the case was that s667C(1) was a relevant factor in determining whether a capital reduction met the requirement to be 'fair and reasonable to the company's shareholders as a whole.'[28] One of Santow J's many

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[25] Subsection 664F(3) of the *Corporations Act*.
[26] Clause 8303, Part 3, Schedule 8 of the *Corporations Regulations*.
[27] Criticism of ASIC Policy Statement 75 by commentators is discussed in Part 5.1.3 of this paper.
[28] Paragraph 256B(1)(a) of the *Corporations Act*.

eloquent statements in the case was that s667C(1) had a ‘strong gravitational pull upon the parallel provisions’ for selective capital reductions.[29]

Chapter 5 will look at Part 6A.2 of the *Corporations Act* in detail and then analyse the extent of s667C’s ‘gravitational pull’ on the provisions relating to compulsory acquisition in the *Corporations Act*; in particular the provisions relating to compulsory acquisition and buy-out rights following a takeover, capital reductions and schemes of arrangement. While the case law on this question is scant, there are signs that s667C provides a level of protection to minority security holders which was not present prior to the commencement of the *CLERP Act*. This likely result is one which may well surprise many commentators and market participants.

[29] (2000) 34 ACSR 737, 753.

2. A description of s667C and Part 6A.2

This Chapter considers the legislative history to the *CLERP Act* reforms to compulsory acquisition and provides a more detailed description of the provisions of Part 6A.2. This analysis will give a framework within which it is possible to consider the technical and policy issues relating to the valuation of securities for the purposes of compulsory acquisition and s667C. The discussion of the legislative history to the *CLERP Act* reforms in particular assist in the interpretation of s667C.

2.1 Legislative history to the CLERP Act reforms to compulsory acquisition

The concept of a statutory definition of fair value for the law of compulsory acquisition appears to have been first conceived in November 1994. It was given legislative form in s667C introduced by the *CLERP Act* on 13 March 2000.

The Companies and Securities Advisory Committee ('CASAC') published an issues paper on Compulsory Acquisition in March 1994. The issues paper did not raise the possibility of a general compulsory acquisition power such as Part 6A.2 or suggest a statutory definition of fair value similar to s667C(1). However it did raise the issue of whether dissenting shareholders under compulsory acquisition under a bid should be given an appraisal right.[30] It also quoted from Delaware's *General Corporation Law*:

> After determining the stockholders entitled to an appraisal, the Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors.[31]

In November 1994 the Legal Committee of CASAC put forward a proposal to replace what was then s701 (compulsory acquisition following a bid) and s414 of the

[30] Legal Committee of CASAC, *Compulsory Acquisitions*, *Issues Paper* (1994) 15.
[31] *General Corporation Law* (Delaware) s262(h). Only the first two sentences of the paragraph are included. The Legal Committee of CASAC quoted a truncated version of these two sentences.

Corporations Law with a new compulsory acquisition power. This proposed compulsory acquisition power was similar to Part 6A.2. The major difference between the proposal and Part 6A.2 was that it was anticipated that a dissenting shareholder would only be allowed to have its shares appraised by the Court. This assessment, which could be either higher or lower than what was offered, would not apply to those shareholders who did not dissent. The dissenting shareholder would not be able to avoid compulsory acquisition entirely.[32]

In relation to the question of valuation, the Legal Committee stated that the independent expert would be required to assess whether the price is fair and reasonable. The first hint at the possible drafting of s667C is their statement that the fact ‘particular shares represent a minority interest which may attract a premium or a discount is to be disregarded.’[33] This concept is picked up in s667C(1)(c).

The influence of the debate surrounding the *Gambotto* decision can be seen in the Legal Committee of CASAC’s final report in January 1996.[34] The Business Law Section of the Law Council of Australia expressed concern that the *Gambotto* decision may lead to reversing the onus on dissidents under s414 and s701 (compulsory acquisition following a takeover bid) and introduce additional disclosure obligations in s701.[35] The Legal Committee expressed agreement with the Court’s approach to challenges to compulsory acquisition under s414 and s701 prior to the *Gambotto* decision (for a discussion of this approach, see section 5.1.2).[36] On the suggestion of the Law Council however the Legal Committee recommended that the ‘legislation should make clear that the *Gambotto* principles do not apply to compulsory acquisitions under s701.’[37]

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[32] Legal Committee of CASAC, *Reforming the law of compulsory acquisitions* (1994) 3. The Legal Committee of CASAC stated that they were considering whether this new compulsory acquisition power should apply to securities other than voting shares.
[33] Ibid 4.
[34] Legal Committee of CASAC, *Report by the Legal Committee on Compulsory Acquisitions* (1996).
[35] Ibid 8. This concern appears to be based on the nature of the compulsory acquisition cases referred to in the *Gambotto* decision – see Ian Renard, ‘The Implications of Gambotto for Takeovers: A Comment’ in Ian M Ramsay (ed.), above n 2, 76.
[36] Legal Committee of CASAC, above n 34, 38-39.
[37] Ibid 40 (Recommendation 12).

The Legal Committee also considered that a legislative definition of fair value should be adopted for the court to assess fair value. The Legal Committee again made reference to the Delaware provision[38] and then enunciated a test very similar to s667C(1):

> The Legal Committee also considers that there should be some non-exhaustive legislative guidance on assessing the fair value of the offer price. It notes that the terms for compulsory acquisition under s701 must be the same as those for the takeover bid. Given this, a court should:
>
> - assess the value of the company as a whole and determine the value of each class of issued security, taking into account its relative financial risk and its distribution rights[;]
> - expressly disregard whether the remaining securities of the offer class should attract a premium or discount.[39]

The Legal Committee also recommended a new compulsory acquisition power in addition to s701 which was similar to the present Part 6A.2.[40] The Legal Committee recommended that independent experts and the Court, in determining fair value, should refer to the definition mentioned above.[41] The Legal Committee implied that the Court's function in reviewing compulsory acquisition under the proposal should be limited to the determination of fair value. However they did not state explicitly that other factors should not be taken into account.

The final report by the Legal Committee was immediately taken up as a proposal under the Corporations Law Simplification Program without any specific mention made of a statutory definition of fair value.[42] CASAC's recommendation for a new compulsory acquisition power and its definition of fair value was adopted as a recommendation of the Corporate Law Economic Reform Program's 1997 report.[43] The report proposed that the Court's role in relation to challenges following a bid would be to determine fair value

[38] Ibid 42 (fn 99).
[39] Ibid 45-46.
[40] Ibid 75-86.
[41] Ibid 81 and 85.
[42] Simplification Task Force, Attorney-General's Department, *Corporations Law Simplification Program, Takeovers – Proposal for simplification* (1996) 11.
[43] The Treasury, *Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 4, Takeovers – Corporate control: a better environment for productive investment* (1997) 28-31.

under the statutory definition.[44] Again it is not clear whether this proposal would extend to excluding considering other factors.

The Corporate Law Economic Reform Program's second report in 1998 contained draft provisions which included a provision that was identical to the present s667C(1)[45] and a provision that was identical to the present s661E(2). The latter stated that the Court may order that securities not be compulsorily acquired following a bid 'if the Court is satisfied that the consideration is not fair value for the securities.'[46]

The second report also provided some explanation as to how the proposed definition of fair value was supposed to operate:

> It is proposed that experts would not account for premiums on account of the **special value of the outstanding securities to the acquirer**, or discounts on account of the lack of a market for particular securities. (emphasis added)[47]

The above statement is repeated in the Explanatory Memorandum to the CLERP Bill.[48] The Explanatory Memorandum contended that extending compulsory acquisition to all securities would 'discourage minority shareholders from demanding a price for their securities that is above a fair value (often referred to as "greenmailing")'[49].

Another important comment in relation to s667C(1) was made by the Parliamentary Joint Committee on Corporations and Securities in its Report on the Corporate Law Economic Reform Program Bill 1998, which stated that the proposed 'section 667C [s667C(2) had yet to be proposed] proscribes a new method of valuing company securities for the purposes of compulsory acquisition.'[50]

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[44] Ibid 28.
[45] The Treasury, *Corporate Law Economic Reform Program, Draft Legislative Provisions* (1998) clause 116.
[46] Ibid clause 94(2).
[47] The Treasury, *Corporate Law Economic Reform Program, Commentary on Draft Provisions* (1998) 107.
[48] The Parliament of the Commonwealth of Australia, House of Representatives, *Corporate Law Economic Reform Program Bill, Explanatory Memorandum* (1998) [7.45.]
[49] Ibid [7.31].
[50] The Parliament of the Commonwealth of Australia, Parliamentary Joint Committee on Corporations and Securities, *Report on the Corporate Law Economic Reform Program Bill 1998* (1999).

The Legal Committee, in its final report on Compulsory Acquisitions, recommended in relation to the proposed new compulsory acquisition power:

> The offer would be subject to a four month 'relation-back' rule. Where the controlling entity, or any associate, had acquired, or had agreed to acquire, any securities in the relevant class (whether under formal bid or otherwise) in the four months prior to dispatch of its offer, the offer would have to be no less than the highest price paid, or agreed to be paid, for those securities. However, the minimum offer would not necessarily satisfy the fair value requirement.[51]

While the policy behind this proposal was implemented in relation to takeovers in s621(3) of the *Corporations Act*, it was not adopted in relation to Part 6A.2. However the Australian Democrats introduced s667C(2) as a Senate amendment, which was accepted by the government and has a similar policy basis. It provides that:

> Without limiting subsection (1), in determining what is fair value for securities for the purposes of this Chapter, the consideration (if any) paid for securities in that class within the previous 6 months must be taken into account.[52]

In relation to the use of the above material for the purpose of interpreting s667C, s15AB of the *Acts Interpretation Act 1901* provides that the documents referred to above can be taken into account in 'assisting in the ascertainment of the meaning of that provision'.[53] Subsection 15AA(1) provides that in 'the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.'

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[51] CASAC, above n 34, 82.

[52] Commonwealth, Parliamentary Debates, Senate, 14 October 1999, P9293 (Senator Murray).

[53] Section 5C of the *Corporations Act* provides that the *Acts Interpretation Act 1901* as in force on 1 November 2000 applies to the *Corporations Act*. Under the *Corporations Law*, there was a separate provision which substantively replicated s15AB (s109J of the *Corporations Law*). Paragraph 2.4 of the *Explanatory Memorandum to the Corporations Bill 2001* provides that Explanatory material 'of the Corporations Law on which the Bill is based may be found in the explanatory memoranda for the legislation that enacted or amended those provisions'.

2.2 Part 6A.2 of the Corporations Act

2.2.1 Procedure and disclosure

Part 6A.2 applies to securities as defined in s92(3). A person can compulsorily acquire securities in a class of securities if the following preconditions are met:

- The person is a '90% holder' which can occur in the following cases:
    - the person holds, either alone or with a related body corporate, full beneficial interests in at least 90% of the securities (by number) in that class;[54] or
    - where the person's voting power in the company is at least 90% and the securities in the class are shares or convertible into shares, the person holds, either alone or with a related body corporate, full beneficial interests in at least 90% of value of all the securities of the company that are either shares or convertible into shares.[55]
- The person lodges a compulsory acquisition notice under s664(2)(a) at the end of the period of 6 months after the 90% holder becomes the 90% holder in relation to that class or by 13 March 2001, whichever is the later.[56]

There is some uncertainty in relation to the application of these preconditions. The expression 'full beneficial interest' is not defined.[57] ASIC has stated that it is prepared to give relief in the case of a registered managed investment scheme (where the responsible entity is unlikely to have a full beneficial interest in the securities that are scheme property) and where a holder has given 'a mortgage, charge or other security over the holding.'[58] Another issue is that it is unclear as to whether the six month limitation could be circumvented by a holder ceasing to be a 90% holder by selling securities and then

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[54] Subsection 664A(1) of the *Corporations Act*.

[55] Subsection 664A(2) of the *Corporations Act*. Subsection 667A(2) provides that the expert's report that accompanies the compulsory acquisition notice in reliance on s664A(2)(c) must state 'whether, in the expert's opinion, the person (either alone or together with a related body corporate) has full beneficial ownership in at least 90% by value of all the securities of the company that are shares or convertible into shares' and 'set out the reasons for forming that opinion.'

[56] Section 664AA of the *Corporations Act*. This section was introduced through amendments to the *Corporate Law Economic Reform Program Bill* by the Australian Democrats. The Australian Democrats are also responsible for s665D and s665E which require a person to give notice to the company, who must in turn notify its members, when it becomes a 85% holder of securities in a class of securities. See Commonwealth, *Parliamentary Debates*, Senate, 14 October 1999, P9288 (Senator Murray).

[57] For a summary of commentators' views on the meaning of 'full beneficial interest' see *ASIC Policy Proposal Paper: Anomalies and Issues in the Takeover Provisions of the Corporations Law* [64] – [69].

[58] ASIC Policy Statement 171, [PS171.60].

becoming a 90% holder again by purchasing securities, thereby starting the six month period over again. It is likely that a Court would not allow such an easy circumvention of this limitation.[59] ASIC gave relief to Pauls Limited to allow the time for the six month period to stop running during the period that a 90% holder is seeking to have its compulsory acquisition approved under s664F.[60] The consideration for compulsory acquisition of a class of securities under Part 6A.2 must be the same for all minority holders and can only consist of cash.[61]

Section 664C details the requirements for a compulsory acquisition notice. They include the requirement for minority security holders to receive an expert's report.[62] There are specific provisions which relate to experts for the purposes of compulsory acquisition of securities under Part 6A.2 and compulsory buy-outs under Part 6A.1 and Part 6A.2. The expert must be a person nominated by ASIC.[63] There are specific requirements relating to the independence of experts in s667B of the *Corporations Act*.[64] Subsection 667A(1) provides that the expert's report must 'state whether, in the expert's opinion, the terms proposed in the notice give a fair value for the securities concerned' and 'set out the reasons for forming that opinion.'

The compulsory acquisition notice requires disclosure in relation to any other information known to the 90% holder or its related bodies corporate that is material to deciding whether to object to the acquisition and not disclosed in the expert's report.[65] In

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[59] Ian Ramsay, Robert Baxt, Ian Renard, Robert Simkiss and Jon Webster, '*CLERP Explained'* (2000) 3-470.
[60] Katherine Morgan-Wicks, 'The new general compulsory acquisition power: Re-establishing the minority's right to an independent expert' (2001) 19 *Company and Securities Law Journal* 349, 353.
[61] Section 664B of the *Corporations Act*.
[62] Paragraph 664C(2)(b)(ii) of the *Corporations Act*. This provision anticipates that more than one expert's report can be provided.
[63] Paragraph 667A(1)(a) and s667AA of the *Corporations Act*. The requirement for the expert to be nominated by ASIC was introduced through amendments to the *Corporate Law Economic Reform Program Bill* by the Australian Democrats, see Commonwealth, *Parliamentary Debates*, Senate, 14 October 1999, P9288 (Senator Murray). For ASIC's policy in relation to the nomination of experts see ASIC Interim Policy Statement 159, paragraphs [PS 159.76] to [PS 159.87].
[64] For a critique of section 667B in relation to ASIC Policy Statement 75, see Katherine Morgan-Wicks, above n 60.
[65] Paragraph 664C(1)(e) of the *Corporations Act*.

Capricorn Diamonds[66], Warren J concludes that the disclosure requirement in Part 6A.2 is different to disclosure requirements in takeovers and schemes of arrangement:

> However, I observe that the authorities relied on by the defendants with respect to schemes of arrangement and takeover bids are of a general kind. None of those cases is concerned with the materiality of information in the context of a compulsory acquisition under Part 6A.2 of the *Corporations Act*. None of the authorities cited consider the inter-relationship of the compulsory acquisition procedures with the determination by the court of fair value under s664F and the remedy given in respect of misleading statements and omissions in takeover documents (defined to include a compulsory acquisition notice) by s670A.
>
> The scheme cases are otherwise irrelevant. They are concerned with different issues and different tests. Disclosure with respect to schemes of arrangement is very different to the questions raised by Part 6A.2 or, even, with respect to takeover bids. In those arenas questions of disclosure are concerned with the question as to whether the addressee of the information can achieve or might expect to achieve a better outcome. In the context of a compulsory acquisition a different regime applies. There is a particular offer made by the 90 per cent holder incapable of being altered or varied and to which the court must give approval or disapproval according to a fixed statutory criteria of fair value. Hence, the disclosure required is not intended to allow some discrete business assessment to be made by a unitholder as to whether a better outcome might be achieved. The disclosure is only to enable a unitholder to decide whether that which has been proffered is in fact fair value or not fair value. In consequence, the materiality of information for a scheme and for a compulsory acquisition under s664C are different.[67]

Other requirements for a compulsory acquisition notice include the provision of details of any consideration given for securities in the bid class by the 90% holder (or associate) within the last 12 months and information regarding a minority security holder's right to object.[68] The notice must specify an objection period of at least one month.[69] Finkelstein J has recently confirmed in *New Hampton Goldfields Ltd v Harmony Gold (Australia) Pty Ltd*[70], that the 90% holder should specify the commencement of the one month period at the time the 90% holder can assume that the notice is given (3 days after the notice is posted).[71]

[66] [2002] VSC 105.
[67] Ibid [248] to [249].
[68] Paragraph 664C(1)(d) and s664(1)(c) respectively.
[69] Paragraph 664C(1)(b) of the *Corporations Act.*
[70] [2002] FCA 391.
[71] Ibid [25] – [27], referring to s664C(4) of the *Corporations Act*. Finkelstein J also expressed the concern that the compulsory acquisition form approved by ASIC under s350 may mislead 90% holders into not specifying the additional 3 day period in s664C(4) which in turn could mislead minority security holders into thinking that they had one month from actual receipt of the notice.

Commentators have suggested that the failure to comply with the disclosure requirements in s664C, 'destroys the right of compulsory acquisition which would otherwise exist'.[72] This conclusion appears to be supported by Finkelstein J in *New Hampton Goldfields Ltd v Harmony Gold (Australia) Pty Ltd*. In that case there was an allegation that the compulsory acquisition notice was defective and an application was made under s1322(4)(d) for more time to lodge notices of objection. Finkelstein J stated in passing that 'if the notices were invalid there will be no need to deal with these issues [i.e. the extension of time application] first'[73], implying that defective notices would 'destroy' the right to compulsorily acquire. Given that the Court's primary role in Part 6A.2 is to decide whether 'the terms set out in the compulsory acquisition notice give a fair value for the securities'[74], this conclusion appears on first view to be counter-intuitive.[75] The information set out in the compulsory acquisition notice is there to assist a minority security holder in deciding whether to object to the compulsory acquisition. It is arguable that the appropriate remedy for a minority security holder where there is a contravention of s664C and there is a possibility that objectors will hold less than 10% of the remaining securities, is to seek an injunction under s1324 or s1325A preventing compulsory acquisition from taking place until additional information is provided and minority security holders are given more time to lodge objections under s1322(4)(d).

The same commentators contend that the words in s664C(1) 'must prepare a notice in the prescribed form', complying with the various disclosure requirements in the subsection, precludes the Court from using s1322 to cure any failure to comply with s664C(1).[76] Douglas J saw little problem with curing various defects under s1322 in *Pauls2*,

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[72] HAJ Ford, RP Austin and IM Ramsay, *An Introduction to the CLERP Act 1999, Australia's New Company Law* (2000) [6.14].
[73] [2002] FCA 391, [17].
[74] Subsection 664F(4) of the *Corporations Act*.
[75] It also appears to run contrary to CASAC's concern in the context of Part 6A.1 that the *Gambotto* decision may lead to challenges to compulsory acquisition following a bid on disclosure grounds - Legal Committee of CASAC, above n 34, 8-9.
[76] HAJ Ford, RP Austin and IM Ramsay, above n 72, [6.14]. These commentators were of the view however that the procedural requirements of s664C(2)-(5), 'relating to lodgment, service and timing, are expressed differently and it is probable that s1322 would be available to cure procedural defects'.

including an alleged deficiency in disclosure under s664C(1).[77] The issue was argued in more detail in *Capricorn Diamonds*[78]. Warren J followed Douglas J's approach in *Pauls2* and stated:

> Obviously, s1322 is available if needed. The section is cast in terms not confined to any particular part, provision or division of the *Corporations Act*. In other words, the section is available wherever and whenever an irregularity may arise. In particular, s1322(4) is cast in terms that although it is a section that ordinarily and conveniently is described in terms of dealing with irregularities it extends to the case in which but for the remedial order a step taken under the legislation may be seen to be invalid.[79]

Subsection 664E details the requirements for making an objection and the 90% holder's obligation to lodge objection forms and a list of objectors. If the objectors hold at least 10% of the securities subject to compulsory acquisition, the 90% holder must within one month after the end of the objection period send to all minority security holders either a notice that the compulsory acquisition will not occur or a notice that it has applied to the Court for approval of the acquisition.[80]

A 90% holder must apply for Court approval within one month of the objection period.[81] If the 90% holder 'establishes that the terms set out in the compulsory acquisition notice give a fair value for the securities, the Court must approve the acquisition of the securities on those terms. Otherwise it must confirm that the acquisition will not take place'.[82]

2.2.2 Collateral benefits

There is a prohibition against benefits offered, given, or agreed to be given during the objection period that 'is not provided for in the notice' in s664D(1). A similar prohibition applies in s664D(2) where a 90% holder proposes to give a compulsory

[77] (2001) 19 ACLC 959, 962, 965.
[78] [2002] VSC 105.
[79] Ibid [242].
[80] Subsection 664E(4) of the *Corporations Act*. See also s664A(3) and s664F of the *Corporations Act*.
[81] Subsection 664F(2) of the *Corporations Act*.
[82] Subsection 664F(3) of the *Corporations Act*.

acquisition notice within the next four months.[83] Subsection 664D(3) provides for a similar prohibition one month following the objection period and during the course of any proceedings for court confirmation. This prohibition only applies where the benefit 'is not offered to all holders of securities in that class under the notice.'[84] Despite the difference in wording, there is some uncertainty as to whether a settlement of proceedings for court approval, where all minority security holders receive an equitable increase in consideration, would still fall foul of the prohibition as it is not offered or given 'under the notice.' The better view is that the expression 'under the notice' in s664D is designed to clarify the meaning of the words 'to all holders of securities in that class' and not to prohibit benefits given to all holders. However this interpretation of s664D(3) is not assisted by the wording in s664A(6) which provides that the '90% holder's power to compulsorily acquire securities under a notice given under section 664C ends if the 90% holder contravenes section 664D by offering benefits **outside the terms proposed in the compulsory acquisition notice under section 664C'** (emphasis added). In any event there is anecdotal evidence that settlements of court proceedings under s664F are being organised as compulsory acquisitions under s414. Another strange conclusion that arises from these provisions is that subsection 664A(6) does not on its face apply to a contravention of s664D(2).[85]

2.2.3 Court approval

Subsection 664F(3), relating to court approval, specifies that the terms offered under the compulsory acquisition notice must 'give a fair value for the securities'. The definition of 'fair value' in s667C applies to Chapter 6A. Santow J in *Holt v Cox*,[86] quoting from the Canadian decision of *Domglas Inc v Jarslowsky Fraser & Co*,[87] distinguishes between

[83] Subsection 664D(2) of the *Corporations Act*. This prohibition suffers from the same limitation which was present in the old prohibitions against collateral benefits in s698(2) and s698(4) of the *Corporations Law*. It is relatively easy to circumvent the prohibition by ensuring that the period between any evidence of a proposal to compulsorily acquire and the lodgment of the compulsory acquisition notice is small.
[84] Paragraph 664D(3)(d) of the *Corporations Act*.
[85] HAJ Ford, RP Austin and IM Ramsay, above n 72, [6.14].
[86] (1994) 15 ACSR 313, 336.
[87] (1980) 13 BLR 135, 163-164.

‘the fair value’ and ‘a fair value’. ‘The fair value’ implies only one value which is fair while ‘a fair value’ implies ‘various possible fair values’.[88]

There is a question as to whether the Court’s determination of fair value should be as at the date of the notice or whether it should be at the time of the Court hearing. The requirement for Court approval under s664F affects the rights of all remaining security holders, whether they lodged notices of objection or not. Therefore if the Court’s valuation was to be taken as at the date of the compulsory acquisition notice, remaining security holders may be paid out at a later date at an earlier value. In effect the remaining security holder’s interest in the company concerned has conditionally ceased as at the date of the compulsory acquisition notice. This would appear an unreasonable result, particularly for those security holders who had not objected.

Subsection 664F(3) provides that the Court must approve the compulsory acquisition if ‘the terms set out in the compulsory acquisition notice give fair value for the securities’. As this is written in the present tense, it is highly arguable that the Court’s valuation should occur at the time of the Court hearing. However this was not the view taken by Warren J in *Capricorn Diamonds*[89]. Warren J noted that the Court’s enquiry under s664F is the same as the expert’s deliberation under s667A(1)(b). Therefore Warren J concluded that because ‘the inquiry as to fair value is directed to the terms set out in the compulsory acquisition notice both in the case of the expert’s report and in the case of the Court’s determination, the time of the notice is the time at which the issue of “fair value” is to be tested’.[90]

It is likely that other Courts will accept Warren J’s comments. However such a result does seem unfair to minority security holders, particularly those who do not object to the compulsory acquisition. Some may argue that it is likely that the value of the company concerned is unlikely to change from the date of the compulsory acquisition notice to the date of the hearing. That may be the case in a number of situations, but there are likely to

[88] Ibid.
[89] [2002] VSC 105.
[90] Ibid [90].

some situations where for particular reasons (such as unforeseen movements in exchange rates or commodity prices) the value may be considerably different. One possible reform of Part 6A.2 is to give the Courts power to order that interest be paid to the minority security holders from the date of the compulsory acquisition notice to the day of the Court hearing. Such a power is given to Delaware courts in section 262(h) of the *Delaware's General Corporation Law*.

Warren J also held that 'the benefit of distributions that are undeclared at the time of a compulsory acquisition notice accrues to an acquirer under s664A.'[91]

2.2.4 Costs

Subsection 664F(4) provides that the '90% holder must bear the costs that a person incurs on legal proceedings in relation to the application unless the Court is satisfied that the person acted improperly, vexatiously or otherwise unreasonably.' This subsection gives objectors to compulsory acquisition under Part 6A.2 some further negotiation power in incurring legal costs which the 90% holder must bear. However recent Court decisions have displayed a commendable degree of commercial pragmatism in dealing with issues relating to costs. In *Pauls Ltd v Dwyer & Ors* ('*Pauls3*') [92] Douglas J held that the objectors would have to bear the following costs:

- Interlocutory proceedings involving failure by the objectors 'to deliver a proper and compliant statement of issues' and 'expert['s] reports and affidavits'.[93]
- Costs relating to the issue of whether the majority security holder was a 90% holder where it was clearly evident that this was the case.[94]
- Costs relating to the separate representation of Mr Catto and Dr Elkington. In relation to this matter Douglas J made the following comments:

> The second respect in which it is alleged that the respondents acted improperly, vexatiously or unreasonably is in the fact that Mr Catto and Dr Elkington were self represented when Mrs Elkington was represented by solicitors and counsel. It is submitted that the interests of the three respondents who took an active part in the

[91] Ibid [92]. Warren J also accepted alternative arguments by the plaintiff that the compulsory acquisition notice was 'cum' any distributions rather than 'ex' and that a unitholder's interest in a trust includes any potential distributions from that trust – [93]-[98].
[92] [2001] QSC 103.
[93] Ibid paragraph 6.
[94] Ibid paragraph 10.

> litigation were not discernibly different. In my view it was appropriate that only one set of legal representatives appear for all respondents. Mr Catto and Dr Elkington added nothing to the case and, indeed, the bulk of Mr Catto's evidence was ruled out by me as being inadmissible. Nothing that was said by either of those gentlemen assisted me in coming to the conclusions to which I ultimately came. In my view Mr Catto and Dr Elkington should not be allowed any costs of representing themselves on the application.[95]

Douglas J's reasoning appears to have been adopted by Warren J in an unreported interlocutory ruling in *Western Australian Diamond Trust – Capricorn Diamond Investments Pty Ltd v Catto & Ors*.[96] In that matter Warren J made an order limiting the dissenting security holders to one expert witness and warned that 'any parties who are unnecessarily participating in the proceeding by way of separate representation are at risk as to any appropriate order of costs that may ultimately be made.'[97] The approach adopted by Douglas J and Warren J in these cases strikes an appropriate balance between the rights of minority security holders and the 90% holder.

The Full Court of the Supreme Court of Queensland in *Pauls Limited v Milly Elkington*[98] ('*Pauls5*') expressed the view that s664F(4) does not apply to an appeal of a decision under s664F(3) and that costs should follow the event in the ordinary course.

[95] Ibid paragraphs 12-13.
[96] Unreported ruling of Warren J of the Victorian Supreme Court, 17 August 2001.
[97] Ibid.
[98] [2001] QCA 414 (Further Order delivered 23 October 2001).

3. Valuing securities

This Chapter commences with a discussion of the sometimes confusing terminology, which arises in the discussion of the valuation of securities for the purposes of compulsory acquisition. There is a discussion of the major valuation methodologies and how they relate to the terminology previously discussed. There is also a detailed discussion of both the policy relating to compulsory acquisition and how securities should be valued for the purposes of compulsory acquisition. The discussion in the Chapter relating to the decisions by Delaware courts provides an example of where a jurisdiction, which has had more experience in valuing shares than Australian courts, has tackled the issues relating to valuing securities.

3.1 Basic concepts and terminology

The American Law Institute, in its Principles of Corporate Governance, points out that a focus on valuation methodology alone is 'meaningless absent agreement on what is to be measured.'[99] Unfortunately some of the debate, both in Australia and in other jurisdictions, has been less than clear due to a lack of definition of basic terminology. The aim of this section is to provide some conceptual definitions to assist in analysing valuation for the purposes of compulsory acquisition.

Australian decisions on probate and gift duty have held the value of shares or other assets to be the 'fair equivalent in money ascertained by a supposed sale by voluntary bargaining between vendor and purchaser, each of whom is both willing and able, but not anxious, to trade and with a full knowledge of all circumstances which might affect value'.[100] Santow J has referred to this definition in *Holt v Cox* as the '**willing buyer and willing seller test**'.[101]

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[99] The American Law Institute, *Principles of Corporate Governance* (1992) Analysis and Recommendations § 7.22(d).
[100] *Holt v Cox* (1994) 15 ACSR 313, 334.

3.1.1 Portfolio value, minority discount and control premium

In relation to individual securities, which have no value as a control parcel and are traded on a liquid market, the price of the securities on the market is an indicator of the value of those securities. This proposition is reflected in the Australian Accounting Standards which defines the fair value for securities as 'the quoted market price in an active and liquid market', or 'when there is infrequent activity in a market, the market is not well established, small volumes are traded relative to the asset or liability to be valued, or a quoted market price is not available – an estimate of a price for the asset or liability in an active and liquid market.'[102] The efficient market hypothesis ("EMH") takes this reasoning further. EMH postulates that the current market price for a security:

- is the best predicator of its future price; and
- immediately 'assimilates new information provided to the market'.[103]

However the market value of a share often trades at a discount compared to the value of the company as a whole divided by the number of shares on issue. In a simple case where the only shares on issue are voting shares, small parcels of shares which trade on the stock market are likely to trade at a discount to the value of the company divided by the number of voting shares. The value of a parcel of voting shares which does not deliver control is often referred to as the **portfolio value** of the voting shares. The difference between the portfolio value of voting shares and a value determined by dividing the value of the company as a whole by the number of voting shares is described as a **minority discount**. In the United States, minority discounts have been estimated to be as 'high as 35% or more'.[104]

Another way of examining this issue in the case of voting shares is by considering what a willing but not anxious acquirer would pay for a parcel of shares which would deliver

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[101] Ibid.
[102] Australian Accounting Standards Board, *Presentation and Disclosure of Financial Instruments*, AASB 1033 [7.1].
[103] Jeffrey N. Gordon and Lewis Kornhauser, 'Efficient Markets, Costly Information, and Securities Research' (1985) 60 *New York University Law Review* 761, 770.

control, or a level of control, in a company. The following[105] is a list of the various levels of shareholding and their possible effect on control which may point to a value which is higher than their market value:

- A strategic stake of 10% or more would block compulsory acquisition against the wishes of a bidder.
- A stake of 25.1% or more would block a special resolution.
- A dominant but not controlling stake of 40% or more could, particularly in large public companies, grant effective control.
- A controlling stake of 50.1% or more would enable the holder to control the appointment and removal of directors and pass ordinary resolutions.
- A controlling interest of 75% or more would enable the holder to pass a special resolution.
- Total control would entitle the holding company, among other savings, to reap tax benefits, save on compliance costs, and avoid conflicts of interest.[106]

The value, which can be attributed to control parcels, can be measured by considering the premium over the market price paid in takeovers. This is normally described as the **control premium**. Between January 1974 and June 1985 the average control premium paid in Australian takeovers was 29.7% (the median was 18.7%). For the 10 years to November 1995, the average bid premium had declined to 19.7% (the median had also declined to 11.3%).[107]

There is sometimes some confusion in relation to the definition of control premium. One narrow way of defining control premium is to say that it is the converse to a minority discount.[108] However the concept of control premium is often defined more broadly in the business community to be the amount that a buyer is willing to pay over and above the portfolio value of the voting shares to obtain control. This broader definition cannot be precisely defined in comparison to other concepts such as minority discount, portfolio value and synergies. This is because it depends on how much a bidder is willing to pay

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[104] John C. Coates, '"Fair Value" as an avoidable rule of corporate law: minority discounts in conflict transactions' (1999) 147 *University of Pennsylvania Law Review* 1251, 1254.
[105] Adapted from Wayne Lonergan, *The Valuation of Businesses, Shares and other Equity* (3rd ed, 1998) 473-474.
[106] See in particular Quentin Digby, 'Eliminating Minority Shareholdings' (1992) 10 *Company and Securities Law Journal* 105, 107-108 and Elizabeth Boros, above n 3, 286-287.
[107] Philip Brown and Raymond da Silva Rosa, 'Takeovers: who wins?' *The Journal of the Securities Institute of Australia* (Summer 1997) 2, 4.

for a company. There may be cases where a bidder is able to take control of a company for more than the portfolio value of the company but less than the value of the company as a whole. In that case the control premium will not take into account the full amount of a minority discount. Sometimes a bidder pays more for a company than its value as a whole because it thinks it can reap additional value from the merger, either because of savings in combining assets or in terms of better management. This additional value is often referred to as 'synergies'.

3.1.2 Synergies

The concept of 'synergies' is one of the more difficult to define. Coates states that synergies arise 'when two assets are more valuable in combination than in isolation or, put otherwise, when two assets are more valuable when controlled by the same firm than when controlled by different firms'.[109] However, this definition may be too narrow in that it does not include savings, which arise from better management of the target, in isolation from combining the businesses of two entities.

One way of analysing synergies is to unpack the possible ways in which synergies can be achieved. Campbell has considered the various ways in which synergies can be obtained through a merger:[110]

- **Information Additive** – where the market price of a company is lower than its intrinsic value because price sensitive information has not been disclosed.
- **Discrete Mismanagement Additive** – where the company could take action against the mismanagement of its managers. The fact and level of the mismanagement may only be disclosed following a merger.
- **Operative Savings Additive** – where company assets could be put to better use.
- **Reasonable Management Additive** – is the improvement in value, which could be made if the company was placed in the hands of reasonable managers.
- **Super-Reasonable Management Additive** – is the improvement in value, which could be made if the company was placed in the hands of the 'finest available management'.
- **Labour Reduction Additive** – is the cost savings involved in retrenching workers, who are no longer required in the merged entity.

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[108] John C. Coates, above n 104, 1273.
[109] Ibid 1275.
[110] Rutherford B Campbell, 'Fair value and fair price in corporate acquisitions' (1999) 78 *North Carolina Law Review* 101, 113 – 115.

- **Creditor Value Reduction Additive** – where the company could be geared to a greater degree to the benefit of security holders, at the expense of creditors.

Another way in which synergies can be characterised is by looking at the type of synergies, which are available to particular bidders:

- **Universal synergies** – which are available to all acquirers.
- **Endemic synergies** – which are available to only a few acquirers, typically those in the same industry.
- **Unique synergies** – which are only available to the particular bidder.[111]

In considering the types of synergies identified by Campbell, it is clear that all could be primarily characterised as universal synergies with the possible exception of Reasonable Management Additive and Super-Reasonable Management Additive, which depend on quality of a particular bidder's management.

In the case of compulsory acquisition by a majority security holder there are a number of potential synergies, which could be achieved which are not specifically identified by Campbell. It may not be possible for the majority holder and the company to completely merge their operations where the company is not 100% majority owned. For example, moving assets between the companies to achieve their best use may lead to compliance costs.[112] Therefore, operational synergies may still arise from compulsorily acquiring minority security holders.[113]

A majority security holder may wish to utilize the tax losses in the company for its own benefit, which can only occur if it obtains 100% control.[114] A majority security holder may also wish to save on fiduciary monitoring costs, other administrative and reporting costs and the cost of keeping a separate head office for the company.[115] There may also be advantages in 100% ownership in being able to financially restructure a group of

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[111] Tom Copeland, Tim Koller and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* (1990) 332.
[112] Such as complying with the related party provisions, Chapter 2E of the *Corporations Act.*
[113] Elizabeth Boros, above n 3, 286.
[114] Quentin Digby, above n 106, 107
[115] Ibid 107-108.

companies and avoid conflicts of interest.[116] A 100% holder can avoid a difficult minority, whether they are termed 'greenmailers' or otherwise.[117] Majority security holders may also wish to obtain 100% ownership on the basis that they alone would benefit from the improvement they wish to make to the company.[118]

3.1.3 Special value and special benefits

The concept of **special value** arose first in the context of small, unlisted companies. Hope JA, delivering a judgment approved by his fellow justices in the NSW Court of Appeal in *Mordecai v Mordecai* ('*Mordecai*')[119], described the concept of special value as follows:

> It is well-established that if property has some special potentiality which only one person would buy, it is to be valued on the basis of a notional sale to that person.[120]

In *Mordecai,* the defendants were brothers, directors and shareholders of Morpak Packaging Pty Ltd. A third brother died leaving his share in Morpak to his son and appointing the defendants as executors to the will. Following the death of their brother, the defendants effectively closed down the operations of Morpak and set up a partnership to take all of Morpak's business.[121] The Court held that the defendants had breached their fiduciary duty towards the company as directors and as trustees of their brother's estate.[122]

On the question of assessing damages for the breach of duty, the defendants claimed that if they had wanted to sell Morpak with its goodwill to a third party, they would have needed to enter into restrictive covenants precluding them from competing with Morpak

[116] Elizabeth Boros, above n 3, 286.
[117] Ibid.
[118] Ibid 287 and John C. Coates, above n 104, 1328.
[119] (1988) 12 NSWLR 58.
[120] Ibid 70 (per Hope JA). It is different from the concept of special value to owner of property - for example where land is zoned residential but can be used for industrial purposes only by the current owner who is a blacksmith who runs a forge on the land in close proximity to a racetrack. See Callinan J in *Boland v Yates* (1999) 167 ALR 575, 654.
[121] (1988) 12 NSWLR 58, 60 – 61.

or canvassing any of Morpak's clients. As they would not be prepared to do so, they argued that no value should be attached to the goodwill of Morpak.[123] Hope JA rejected this argument. He noted that the goodwill was of value to the defendants and considered the special value argument. However, he also stated that he preferred a valuation approach based on industrial property cases, though he admitted that both approaches came to the same result. In those cases, where a party has infringed copyright, damages are assessed on the amount the person would need to pay to lawfully obtain a licence from the owner.[124] Damages could then be assessed in this case on the basis of the value of the goodwill, which was misappropriated by the defendants.[125]

Therefore the concept of special value was developed by the courts as one way to consider how to value securities where there are no likely purchasers for the securities other than one of the holders. As Santow J stated in *Holt v Cox*:

> There is no real external purchaser that can be hypothesised without resorting to fiction, but only the shareholders themselves. So that it is the value to *them* that is relevant, rather than some external, objective, market value; there is otherwise no market. (emphasis in the original)[126]

It follows that if special value is based on the value of the securities to the particular acquirer, then it would include all forms of synergies, including endemic and unique synergies. **Special benefits** is an expression relating to the concept of special value. It will become clear in discussing the cases relating to s667C in section 4.3 of this paper that the concept of special benefits is not entirely clear, in particular whether it includes universal synergies. For the purposes of general discussion in this paper, special benefits refer to those elements of value, which arise as a result of the compulsory acquisition in question and do not form part of the value of the company to an objective third party purchaser prior to compulsory acquisition. Therefore universal synergies are not

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[122] Ibid 65-66.
[123] Ibid 69.
[124] Ibid 70.
[125] Ibid 71.
[126] (1994) 15 ACSR 313, 334. This concept has also been explored understandably in family law cases where small family companies are valued, see for example the case of *Sapir v Sapir* (No 2) (1990) 13 Fam LR 362, 364-365 referred to by Santow J in *Holt v Cox*.

included in this definition. A bidder who is not in control of the target may hope to extract special value from a takeover of a target because of the nature of the bidder's business. However it is likely that a majority security holder will have a better idea of the amount of special benefits that may be reaped in compulsory acquisition than a bidder who is not in control of the target prior to a takeover.

The concept of special value and special benefits was first applied to a company with a number of security holders (in fact a public company, which had recently delisted) in *Melcann Ltd v Super John Pty Ltd* ('*Melcann*').[127] In this capital reduction case under the old s195 of the *Corporations Law* it was argued that expert valuation, which accompanied the notice of meeting, failed to take into account the value to the majority shareholder (Australian Cement Holdings Ltd – ACH) 'of the synergies involved in its ability after cancellation of the minority shareholdings to merge substantial elements of the company's activities with those of ACH itself.'[128] These synergies included the elimination of 'a separate board and company structure coupled with a fully integrated marketing structure.'[129] The cost savings of achieving an integrated marketing structure were estimated 'as being in the order of $100,000 - $200,000 annually'.[130]

McLelland CJ stated that it was clear that '100% ownership of the company has a special value to ACH of a very considerable financial significance'. As it was not taken into account in determining the fair value of the shares, McLelland CJ was not convinced that the expropriation was fair to the minority shareholders and refused to approve the capital reduction.[131]

The special benefits described in *Melcann* could have comprised some endemic synergies. Part of savings involved in a fully integrated marketing structure could be available to other acquirers in the same industry. The head office savings could perhaps be available to all acquirers who were companies that already had a well organised head

[127] (1995) 13 ACLC 92.
[128] Ibid 93.
[129] Ibid 94.
[130] Ibid.

office. Some of the savings were also likely to be unique as ACH had been the majority security holder for a while and would be best placed to make these savings. These savings were not strictly universal synergies as some acquirers, such as individuals rather than companies, are unable to reap them.

3.1.4 Other considerations

Courts have also recognised that the value of a minority interest in a company whose securities are not listed are of less value to a prospective third party purchaser due to a lack of liquidity for those securities.[132] A similar issue applies to securities which have restrictions in relation to transferability.

3.2 A description of major valuation methodologies

It has been said that 'valuation is an art rather than a science'.[133] The following is a description of the major valuation methodologies. The complete mathematical detail pertaining to these methodologies has been omitted from this exercise, as a general description is sufficient to discuss these methodologies in the light of the issues raised in section 2.1 above.

3.2.1 Discounted cash flow valuation

The theoretical basis for the discounted cash flow ('DCF') valuation is that 'an asset is worth its future cash flows, discounted to recognise the risk of achieving these cash flows and the time span over which they will be achieved'.[134] Cash flow 'is the difference

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[131] Ibid.
[132] *Re Golden Bread v Hutchinson* [1977] Qd. R. 44, 63 and *Re a Company No. 002612 of 1984* (1986) 2 BCC 99,452, 99,486.
[133] *Matter of Shell Oil Co*. 607 A.2d 1213, 1221 (1992). See a similar quote in Wayne Lonergan, above n 105, 3.
[134] Wayne Lonergan, above n 105, 58.

between “dollars-in” and “dollars-out” ’.[135] It is therefore different to the accounting earnings or profits. For example:

- Capital expenditure is taken into account when the capital expenditure is undertaken rather than booking a depreciation expense.
- Tax expense is taken into account when it is paid rather than incurred.[136]

A DCF valuation ‘requires the following:

- Future cash flow estimates over a relevant period of time.
- Estimation of the terminal value at the end of the time period.
- Assessment of an appropriate discount rate.’[137]

The following is a simple formula for a DCF valuation:

$$PV = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \frac{\text{Terminal Value}}{(1+r)^n}$$

Where:

PV = present value of a company or asset.
CF = cash flow in a given year.
r = discount rate (otherwise known as the required rate of return).
n = the number of years the cash flow is to be discounted.[138]

Thompson states that the Terminal Value can be calculated by way of a constant growth model, a competitive equilibrium model, a price earnings rule of thumb or a market book rule of thumb.[139] The longer the period that cash flows are forecast, the less impact the calculation of Terminal Value becomes given the rate of discount.[140]

[135] Samuel C., Thompson, Jr., ‘A Lawyer’s Guide to Modern Valuation Techniques in Mergers and Acquisitions’ (1996) *The Journal of Corporation Law* 457, 481.
[136] Ibid.
[137] Wayne Lonergan, above n 105, 59.
[138] Adapted from Samuel C., Thomspon, Jr., above n 135, 478 and Wayne Lonergan, above n 105, 57.
[139] Samuel C., Thomspon, Jr., above n 135, 489 – 490.
[140] Wayne Lonergan, above n 105, 78.

In a simple valuation of a company where there is no debt, the discount rate is normally determined under the capital asset pricing model ('CAPM'). The CAPM is 'based on the theory that a prudent investor will price assets so that the expected return is equal to:

- the risk free rate of return; plus
- a premium for risk'.[141]

The CAPM expressed in a formula is as follows:[142]

$$r = Rf + \beta[Rm - Rf]$$

Where:

r = cost of equity capital (discount rate).
Rf = Risk free rate of return which is usually based on long-term government bond rate.
ß = Beta of the company's securities. Beta 'is the measure of the sensitivity of a security's return to market movements'. Therefore if the Beta of a company's securities is equal to 1, then it moves in line with the market. If the Beta of a company's securities is 1.5, then a market rise of 10% would lead on average to a 15% rise in the company's securities.[143]
E(Rm) = Expected return on the market. Lonergan states that empirical studies 'have shown that the market return is generally 6 to 8 per cent above the risk free rate of return.'[144]

The most common way in which financing is taken into account in valuation under the DCF valuation method is by calculating using as the discount rate the Weighted Average Cost of Capital ('WACC'). Essentially, the WACC is derived by giving weightings to separate discount rates for equity ('CAPM') and debt, and adding these discount rates. The weightings are derived by the proportion of the companies' assets which are made up of equity and debt respectively.[145]

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[141] Ibid 139-140.
[142] Ibid 140.
[143] Samuel C., Thomspon, Jr., above n 135, 508.
[144] Wayne Lonergan, above n 105, 141.
[145] WACC is therefore calculated as follows:

$$WACC = K_e \frac{E}{D+E} + K_d(1-T)\frac{D}{D+E}$$

Where:
Ke = cost of equity capital.
Kd = cost of debt before tax.
T = corporate tax rate.

DCF valuation is considered by commentators to be the 'most theoretically sound valuation methodology.'[146] Grant Samuel and Associates stated, in their Independent Expert's Report in Relation to the Takeover Offer by Rio Tinto Limited, that discounting 'of projected cash flows has a strong theoretical basis'.[147] The Supreme Court of Delaware has stated that in 'many situations, the discounted cash flow technique is in theory the single best technique to estimate the value of an economic asset'.[148] It is widely used in the United States. In Australia it is the preferred valuation method for valuing established mining companies.[149]

A DCF valuation values the company as a whole and therefore:

- does not include a minority discount; and
- takes into account a control premium to the extent that a control premium is the converse of a minority discount.[150]

One major drawback with DCF valuation is that it depends on cash flow forecasts which may at times be unreliable.[151]

D = market value of debt.
E = market value of equity.
See Wayne Lonergan, above n 105, 149.

146 Ibid 58.

147 Grant Samuel and Associates Pty Ltd, *Comalco Limited – Independent Expert's Report in Relation to the Takeover Offer by Rio Tinto Limited* (26 April 2000) 51-52.

148 *Cede & Co. v Technicolor, Inc., 1990 Del.Ch.* LEXIS 259, 23 (overturned on other grounds on appeal Del. Supr., 684 A 2d. 289 (1996)).

149 Grant Samuel and Associated Pty Ltd, above n 147, 52 and PricewaterhouseCoopers Securities Limited, *Independent Expert's Report in relation to the proposed selective capital reduction by Goldfields Kalgoorlie Limited under Section 256B of the Corporations Law* (15 May 2000) 25.

150 *Steiner Corporation v Bertha Benninghoff and Others* 5 F. Supp. 2d 1117, 1124 (1998) (United States District Court for the District of Nevada), John C. Coates, above n 104, 1285 and PricewaterhouseCoopers Securities Limited, above n 149, 25.

151 Barry M. Wertheimer, 'The Shareholders' Appraisal Remedy and how the Courts Determine Fair Value' (1998) 7 *Duke Law Journal* 613, 630.

3.2.2 Capitalisation of Future Maintainable Profits

This valuation methodology involves estimating the likely annual maintainable profits of a company and then multiplying this figure with a price earnings ratio ('PER') which is an average of the PERs for comparable companies.[152] A PER for a company is determined by dividing the market value of the company by its earnings.[153] Lonergan argues that compared with mining and extractive industries, it is often 'too difficult and subjective' to forecast cash flows for industrial and commercial entities. Therefore he suggests that for these industries Capitalisation of Future Maintainable Profits is the preferred valuation method.[154]

Where the PER in a Capitalisation of Future Maintainable Profits valuation is based on market prices, the valuation will be based on a portfolio value that includes a minority discount.[155] One way to include a control premium in a Future Maintainable Profits valuation is to use PERs from similar transactions.[156] It is difficult to determine exactly the extent of control premium, synergies or special benefits to be included in such a valuation as it depends on the extent to which similar transactions involved the payment of a control premium, synergies or special benefits.[157]

One difficulty with the Capitalisation of Future Maintainable Profits method is that there may be some cases where there are few comparable companies or transactions. There

[152] Wayne Lonergan, above n 105, 29-45. These multiples can be based on earnings before interest and tax (EBIT) and earnings before interest, tax and depreciation (EBITDA).
[153] Ibid 31.
[154] Ibid 14.
[155] John C. Coates, above n 104, 1341, *Steiner Corporation v Bertha Benninghoff and Others* 5 F. Supp. 2d 1117, 1124 (1998) and *Borruso and Lee v. Communications Telesystems International* 753 A. 2d 451, 457 (1999).
[156] An example of the use of PERs from similar transactions (together with PERs of similar companies) can be found in Grant Samuel and Associates Pty Ltd, *Pioneer International Limited, Independent Expert's Report* (January 2000) 58, 59 and Appendix 2.
[157] *Steiner Corporation v Bertha Benninghoff and Others* 5 F. Supp. 2d 1117, 1137 (1998). In *Onti Inc. v Integra Bank* 751 A. 2d 904, 913 (1999), the court refused to 'specifically consider studies of control premiums paid in merger transactions because those reflect expected future profits after the merger (i.e., synergy values)'.

have been two decisions in the United States which have rejected this method on the basis of a lack of truly comparable companies.[158]

3.2.3 Asset Based Valuations

Valuing a company on the basis of valuing its assets may be appropriate in the case where the company is not deriving sufficient revenues from its assets. For example in *Bell v. Kirby Lumber Corporation* ('*Kirby*'), an appraiser valued a lumber company at US$120 per share as a going concern and at $456 per share on an asset valuation basis.[159]

One form of Asset Based Valuation is a valuation based on a hypothetical orderly realisation of assets and repayment of liabilities. Such a valuation was undertaken by both SG Hambros Australia Limited[160] (for Hudson Conway) and PricewaterhouseCoopers[161] (for ASIC) in the Hudson Conway scheme of arrangement. At the time the scheme was proposed, Hudson Conway's primary asset was shares in Publishing and Broadcasting Limited.

3.2.4 Capitalisation of dividends

A Capitalisation of Dividends methodology is similar to Capitalisation of Future Maintainable Profits. It involves dividing future maintainable dividends with a capitalisation rate, which is calculated by averaging the dividend yields of similar securities.[162]

This valuation methodology gives a valuation of securities which excludes any prospect of capital gain, control premium or synergies. Lonergan argues that a Capitalisation of

[158] *In re Radiology Associates Inc.* 611 A. 2d 485, 490 (1991) *Gilbert v. MPM Enterprises, Inc.*, 709 A. 2d 663, 667 (1997).
[159] 413 A. 2d 137, 140 (1980).
[160] SG Hambros Australia Limited, *Independent Expert's Report for the Shareholders of Hudson Conway Limited* (5 November 1999).
[161] PricewaterhouseCoopers, *Subject: Hudson Conway Limited – Share Scheme*, 11 November 1999.
[162] Wayne Lonergan, above n 105, 112.

Dividends methodology is appropriate for minority shareholdings in unlisted companies.[163]

A Capitalisation of Dividends methodology is often used in the case of preference shares which are not converting or convertible and which have limited voting rights. In DMR Corporate Pty Ltd's valuation of preference shares in National Consolidated Limited,[164] DMR compared the dividend yields of cumulative preference shares of twelve listed public companies.[165] DMR then divided the annual dividend of National Consolidated's preference shares with low, average and high capitalisation rates to determine the value of the preference shares.[166] National Consolidated preference shares were cumulative, not convertible or converting, and only carried voting rights in limited circumstances.[167]

3.2.5 Valuation of Options

The intrinsic value of an option is the difference between the company's share price and the exercise price of the option.[168] Where the intrinsic value of the option is negative, the option is out of the money. There is also a value in an option, which represents the time value of money, so that even out-of-the-money options have a value because of the potential for the option to have a positive intrinsic value prior to the expiry of the option.

One way to value an option, which includes the time value of money, is the Black and Scholes valuation. The Black and Scholes valuation is based on some underlying assumptions including that the underlying securities pay no cash dividends during the life of the option and that the option is European – meaning that it can only be exercised on a specific expiration date.[169] Lonergan cautions that out of the money options may be

[163] Ibid 107.
[164] DMR Corporate Pty Ltd, *Expert report addressed to Mr PJ Kershaw, Finance Director, Austrim Nylex Limited* (January 2001).
[165] Ibid 9.
[166] Ibid 10. For example for the high valuation, DMR divided the annual dividend ($0.10) with the capitalisation rate (6.23% or 0.0623) to come up with a valuation of the National Consolidated Preference Shares of $1.61.
[167] Ibid 8.
[168] Wayne Lonergan, above n 105, 158.
[169] Ibid 166.

overvalued under this methodology.[170] Lonergan used a Block and Scholes valuation to assess the potential benefit to Edensor in the Yandal litigation.[171]

Options can also be valued on their fundamental value, which is 'the difference between the share value and the option exercise price, taking into consideration the benefit to the option holder of having the use of the funds required to exercise the option less the present value of the foregone dividends on the shares.'[172]

One difficult question in relation to the compulsory acquisition of options issued by a company is whether the valuation of the options should be based on the portfolio value of the underlying securities or some other valuation of the underlying securities.

3.3 Valuation of securities in compulsory acquisition

There are various ways in which the value of securities can be determined for the purposes of compulsory acquisition:

- For securities valued on a securities exchange, the value can be determined by reference solely to the market price.
- Securities can be valued by an expert. The question then becomes whether the expert should take into account a minority discount, control premium or synergies (in their various forms).
- After considering relevant information, a majority of the minority security holders approve the compulsory acquisition at a particular price.

The purpose of this section is to consider from a policy perspective what price minority security holders should be paid where the securities are compulsorily acquired. A policy discussion on the basis for compulsory acquisition provides a good theoretical basis for considering s667C and the valuation of securities for the purposes of compulsory acquisition generally. A number of the issues relating to the valuation of securities in compulsory acquisition have arisen from *Gambotto* and the debate surrounding the

[170] Ibid.
[171] *ASIC v Yandal Gold Pty Ltd* (1999) 32 ACSR 317, 355-356.
[172] Wayne Lonergan, above n 105, 166.

decision. Therefore it is useful to commence discussion of this issue in light of the *Gambotto* debate.

3.3.1 The situation if there was no compulsory acquisition.

The majority in *Gambotto* were of the view that just because an amendment to the company's constitution would 'advance the interests of the company as a legal or commercial entity or those of the majority, albeit the great majority, of corporators', this did not provide 'sufficient justification' for compulsorily acquiring shares by way of an amendment to the company's constitution. They stated that to conclude otherwise 'does not attach sufficient weight to the proprietary nature of a share.'[173]

This statement of the proprietary nature of a share has caused considerable debate amongst commentators.[174] Some commentators have drawn a conceptual distinction between a property rule and a liability rule of share ownership. A property rule would lead to the conclusion that compulsory acquisition of shares was indefensible. A liability rule would allow for compulsory acquisition of shares at a fair price.[175]

Various difficulties would arise if compulsory acquisition of shares and other securities were not permitted. Where a minority security holder could not be contacted, a company may be prohibited entirely from reaping the fruits of consolidation.

Even where minority security holders could be contacted, those security holders would be in a strong bargaining position. A majority security holder would be able to benefit out of purchasing the minorities' securities so long as the amount paid was less than the benefits to the majority security holder of consolidation and transaction costs. Therefore

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[173] (1995) 182 CLR 432, 446.
[174] Note for example Deborah A DeMott, 'Proprietary Norms in Corporate Law: An Essay on Reading Gambotto in the United States' in Ian M Ramsay (ed), above n 2, 90, Michael J Whincop, 'An Economic Analysis of Gambotto' in Ian M Ramsay (ed), above n 2, 102, Saul Fridman, 'When Should Compulsory Acquisition of Shares be Permitted, and, if so, What Ought the Rules be?' in Ian M Ramsay (ed), above n 2, 117, Peta Spender, above n 2 and Helen Bird, above n 2.
[175] Deborah A DeMott, above n 174, 97, Saul Fridman, above n 174, 118, 131.

it is possible that minority security holders may be able to obtain more than their pro rata share of synergies, including special value, which attach to consolidation. Irrespective of issues relating to economic efficiency, such a result would seem inequitable.

It was this result which led to reform in both the United States of America and Commonwealth jurisdictions. In nineteenth century America, any fundamental corporate change required the unanimous consent of all shareholders. Problems relating to such a rule lead to the introduction of legislative merger provisions and appraisal rights.[176] In the United Kingdom and Australia, the forerunner to s414 (and indirectly to Part 6A.1) of the *Corporations Act* was introduced following the recommendations of the Greene Committee[177] who also took into account this issue:

> 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 materialise.
>
> In our opinion this position – which is in effect an oppression of the majority by a minority - should be met.

Considering what the situation would be if compulsory acquisition of securities was prohibited provides some assistance in determining how securities should be valued for the purposes of compulsory acquisition. If securities were to be valued in such a way that the minority security holders received all of the synergies (including special benefits), then it is fairly clear that compulsory acquisition would be of little benefit to majority security holders.[178] In cases where all minority security holders were contactable, majority security holders would rationally prefer no legislative power to compulsorily acquire securities compared to compulsory acquisition where minority security holders received all of the synergies and special benefits, as that would leave room for them to negotiate a deal which left them with some of the synergies. Compulsory acquisition on

[176] Deborah A DeMott, above n 174, 99.
[177] Parliament of the United Kingdom, *Company Law Amendment Committee Report* (1925-1926) 43, 44.
[178] A similar comment was made by Giles JA in *Winpar Holdings Ltd v Goldfields Kalgoorlie Ltd* (2001) 40 ACSR 221, 250.

such a basis would also lead to the perverse result that the minority's securities would become more valuable as 'they were progressively eliminated.'[179]

Therefore if minority security holders are to share in some or all of the synergies under compulsory acquisition, it should be undertaken on a pro rata basis.

3.3.2 Compulsory acquisition at market price

It is also instructive to consider the other extreme. There are a number of commentators who take the view that majority security holders should be able to eliminate minority security holders at the price that these securities trade on market. In summary these commentators argue:

- in favour of EMH theory - that the best indicator of value of a security is its current market price;
- that eliminating minority security holders at the current market price ensures the greatest number of value-enhancing transactions which improve management performance; and
- minority security holders, who hold a portfolio of securities will benefit more in the long run under such a rule because the benefits they will obtain in holding securities of bidders and majority security holders outweighs any disadvantages that they may suffer as minority security holders.[180]

There is some judicial support for this proposition in United Kingdom compulsory acquisition cases. Parry J in *Re Press Caps* stated that the 'final test of what is the value of a thing is what it will fetch if sold.'[181] Plowman J in *Re Greirson Oldham & Adams Ltd.*, stated that market value of the shares 'is cogent evidence of their true value; not conclusive evidence, of course, but cogent evidence.'[182] Australian courts have showed slightly less enthusiasm for market prices as a determinant of value. For example, in *Kingston & Anor v Keprose Pty. Ltd. (No. 2)* Bryson J stated that the supposition that 'the

[179] Quentin Digby, 'The Implications of Gambotto for Non-Takeover Aspects of Compulsory Acquisitions A Comment' in Ian M Ramsay (ed), above n 2, 72.
[180] Frank H. Easterbrook and Daniel R. Fischel, 'Corporate Control Transactions' (1982) 91 *Yale Law Journal* 698.
[181] [1948] 1 Ch. 434, 447.
[182] [1968] 1 Ch. 17, 32.

price at which shares in a listed company may be sold equates or relates to that value' is very 'unreliable, as well illustrated by common experience.'[183]

The High Court in *Gambotto* shows a similar degree of skepticism towards the reliability of market prices. The majority did affirm 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 was not a fair value'.[184] McHugh J also acknowledged that 'payment of compensation which accords with the market value of the expropriated shares will go a long way to preventing the expropriation from being classified as oppressive.'[185]

However, both the majority and McHugh J referred to the leading Delaware decision of *Weinberger v U.O.P. Inc* ('*Weinberger*')[186] as support for the proposition that factors other than market price need to be taken into account. The particular passage from *Weinberger* that McHugh quotes directly, and the majority paraphrase, is that an estimation of fair price includes 'all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.'[187]

McHugh J went further than the majority in discussing the issue of market price. McHugh J stated at first that the 'market price of shares on a security exchange is cogent evidence of value.'[188] However later, after referring to *Weinberger*, he disagreed with the proposition enunciated in *Re Sheldon; Re Whitcoulls Group Ltd*. that in the case of listed shares, 'it would be rare indeed that a Court could be satisfied that a price substantially higher than that ruling on the public market was anything other than a fair value for those

[183] (1988) 6 ACLC 111, 118.
[184] (1995) 182 CLR 432, 447.
[185] Ibid 457.
[186] 457 A. 2d 701 (1983).
[187] Ibid 771.
[188] (1995) 182 CLR 432, 457, quoting from *Elkington v Shell Australia Ltd* (1993) N.S.W.L.R., 22.

shares.'[189] In disagreeing with that proposition, he made a general statement about market prices for securities:

> 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 per cent 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. 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.[190]

This statement by McHugh J has been the subject of much criticism from commentators who are supporters of the EMH theory. For example Whincop argues that:

> 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 by 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.[191]

However similar observations to those made by McHugh J have also been made in Delaware. In *Chicago Corp. v Munds*[192], the Delaware Supreme Court stated the following, five years after the 1929 Wall Street crash:

> When it is said that the appraisal which the market puts upon the value of the stock of an active corporation as evidenced by its daily quotations, is an accurate, fair reflection of its intrinsic value, no more than a moment's reflection is needed to refute it. There are too many accidental circumstances entering into the making of market prices to admit them as sure and exclusive reflectors of fair value. The experience of recent years is enough to convince the most causal observer that the market in its appraisal of valued must have been woefully wrong in its estimates at one time or another within the interval of a space of time so brief that fundamental conditions could not possibly have become so altered as

[189] (1987) 3 NZCLC 100,058, 100,060.
[190] (1995) 182 CLR 432, 458.
[191] Michael J Whincop, above n 174, 113.
[192] 172 A. 452, 455 (1934).

> to affect true worth. Markets are known to gyrate in a single day……Even when conditions are normal and no economic forces are at work unduly to exalt or depress the financial hopes of man, market quotations are not safe to accept as unerring expressions of value. The relation of supply to demand on a given day as truly affects the market value of a stock as it does of a commodity; and temporary supply and demand are in turn affected by numerous circumstances which are wholly disconnected from considerations having to do with the stock's inherent worth.

This comment was quoted with approval five years after the October 1987 stock market crash by the Delaware Supreme Court in *Rapid-American Corp v. Harris*:

> *Munds*' succinct evaluation of the market has lost none of its lustre. Recent price changes in the stock market dramatically illustrate the defects of an *overstated* reliance on market price to determine a corporation's intrinsic value in an appraisal proceeding (emphasis in the original).[193]

The above passages highlight one of the problems with the use of market price of securities as an indicator of value. While some commentators would disagree with the proposition that market prices are affected by factors 'which are wholly disconnected from considerations having to do with the stock's inherent worth', it is difficult for these commentators to refute the proposition that there is volatility in market prices. While such volatility can be ameliorated by determining average market prices over a period of time, there is a still a problem using market prices where the market is illiquid. One commentator has remarked that 'anything less than a deep market for the shares can make market price highly volatile when there are slight changes in trading volume.'[194] DeMott speculates that such concerns may be more relevant in smaller markets such as Australia than in the United States.[195]

Another problem with market prices stems from the fact that majority security holders choose the time for expropriation and usually have greater access to company information. Part of McHugh J's skepticism over the use of market prices may stem from his statement that shareholders 'whose shares are to be expropriated have no say

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[193] 603 A.2d 796, 806 (1992).
[194] Note 'Using Capital Cash Flows to Value Dissenters' Shares in Appraisal Proceedings' (1998) 111 *Harvard Law Review* 2099, 2101.
[195] Deborah A DeMott, above n 174, 100.

concerning the timing of the expropriation.'[196] Earlier in his judgment, he referred to Digby's comment that depressed prices following the October 1987 share market crash gave 'the expropriators the chance to acquire the shares at a price below their "fundamental value" '.[197] This observation was also made by the National Companies and Securities Commission in its submission to the Edwards Committee.[198]

A majority security holder will usually have access to information that may affect the market price, which is not known to the market or to minority security holders.[199] A majority security holder, therefore, may be tempted to withhold positive information about the company for its own ends or may choose an appropriate time to commence compulsory acquisition when it is in a position to legally withhold positive information about the company, for example where the information is within a 'carve-out' under the continuous disclosure rules.[200]

Not only can majority security holders be in a position to pick the right time to undertake compulsory acquisition of the minority, they can also manage a company's affairs in such a way as to depress the market price of securities to their benefit.[201] One example of this was the case of *Kirby*, referred to in section 3.2.3 above. In that case the market may have discounted the value of the shares considerably because the majority security holder was using the assets of the company for a lumber business rather than putting them to a better use by selling the assets and distributing the balance to the shareholders. If a majority security holder was able to compulsorily acquire the shares in a company such as this at market price and then sell the assets of the company, the majority security holder may be able to obtain a significant windfall gain from the procedure. It has been recognised in two High Court decisions that where the earnings of a company do not reflect its true value, for example where assets are not being put to best use or where a family company is used as a means to hold assets rather than necessarily to earn income,

[196] (1995) 182 CLR 432, 458.
[197] Ibid 456, quoting from Quentin Digby, Quentin Digby, see above 106, 124.
[198] Commonwealth, *Report of the Joint Select Committee on Corporations Legislation* (1989) [13.35] – [13.36], quoted in Elizabeth Boros, above n 3, 284.
[199] Barry M. Wertheimer, above n 151, 638.
[200] ASX Listing Rule 3.1.

it is appropriate to value shares on an orderly realisation of assets basis rather than an earnings based valuation.[202]

It follows from this analysis that a rule which requires compulsory acquisition at market price may lead to issues of moral risk in that it may encourage majority security holders to undertake oppressive or opportunistic behaviour.[203] Therefore the argument that security holders would not mind such a rule because they can hold diverse portfolios which include holding securities in majority security holders is not conclusive. Encouraging oppressive and opportunistic behaviour may lead to economically disadvantageous outcomes.

Another argument against the use of market price to determine the value of securities is that the presence of a control block of securities in a company in itself will depress the market price.[204] The presence of a control block of securities in a company as depressing the price of securities on the market was noted by Rogers AJA in *Catto v Ampol Ltd*.[205] A similar comment was made by Bryson J in *Nicron Resources Ltd v Catto*[206]:

> The idea that a fair money equivalent of the shares is to be established by reference to trading in small numbers of shares in a thin market in which only a maximum of 1.8% of all of the shares on issue can be traded is simply incorrect, incorrect on its face.

Whincop's rationale for criticising McHugh J however, is more compelling when considering the price reached by a successful bidder in a takeover. In these cases well advised parties have made an assessment of the value of the target company. It is fair to say that what successful bidder is willing to pay for a company is a better indicator of value than what a judge determines starting from scratch. This concept will be further explored in section 3.3.4 below.

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[201] Barry M. Wertheimer, above n 151, 638.
[202] *In the Marriage of Mallet* (1984) 52 ALR 193, 203 (Gibbs CJ), 211 (Mason J) and *Commission for Stamp Duties (NSW) v Pearse* (1951) 84 CLR 490.
[203] Barry M. Wertheimer, above n 151, 644.
[204] Ibid 640.
[205] (1989) 15 ACLR 307, 323.
[206] (1992) 8 ACSR 219, 242.

3.3.3 Should a minority discount apply?

Of course a valuation of a company's securities can be undertaken which produces a valuation at portfolio value which removes or ameliorates any imperfections in market price and can also be used for valuation of securities which are not traded. For example, a minority discount can be applied to a DCF valuation or securities can be valued by use of the capitalisation of future maintainable profits method (using a market based PER). Therefore, there is a question as to whether a valuation of securities for the purposes of compulsory acquisition should include a control premium or whether a minority discount should be applied.

Many supporters of the EMH theory would argue that a minority discount should apply because any control benefits belong to the controlling security holder rather than the minority.[207] In relation to voting shares, this principle however runs contrary to the equality of benefits principle in Australian takeover law (s602(c) of the *Corporations Act*). Paragraph 602(c) provides, in relation to voting shares, that:

> As far as practicable, the holders of the relevant class of voting shares or interests all have a reasonable and equal opportunity to participate in any benefits accruing to the holders through any proposal under which a person would acquire a substantial interest in the company, body or scheme.

This principle and provisions of the *Corporations Act* which support it, such as s623, would imply that minority voting shareholders should share in at least part of the control premium which may apply in compulsory acquisition of their shares. Coates has made a similar comment in the American context. He notes that an argument that a minority discount should not apply because it offends an equality of benefits principle is not a strong argument in the American context as such a concept does not apply in the takeover laws of most American jurisdictions.[208]

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[207] Frank H. Easterbrook and Daniel R. Fischel, above n 108, 698 and Justin Mannolini, 'The Reform of Takeovers Law – Beyond Simplification' (1996) 14 *Company and Securities Law Journal* 471, 474.
[208] John C. Coates, above n 104, 1338-1339.

An example of where a market price was rejected on the basis that it offended the equality of opportunity principle was in *Catto v Ampol*. In April 1987 Pioneer, which held more than 75% of the ordinary shares in Ampol, purchased 61% of Ampol's preference shares at $4 per share without making a takeover bid. Rogers AJA noted that at 6% per annum and with limited voting rights, these $2 preference shares had understandably traded at less than $2 as at February 1987.[209] However the holders of preference shares could collectively appoint a director to the board of Ampol and Rogers AJA surmised that Pioneer purchased 61% of the preference shares to ensure that it could elect this director.[210] A year later Pioneer made offers under a takeover bid for the preference shares at $2.75 per share which resulted in Pioneer's holding of Ampol preference shares reaching 82 per cent. Ampol, now clearly controlled by Pioneer, then proposed a capital reduction to eliminate the minority preference shareholders at $2.78 per preference share.

The New South Wales Court of Appeal held that it should read the capital reduction provisions in the light of the *Companies (Acquisition of Shares) Code 1981* ('*CASA*' - the forerunner to Chapter 6 of the *Corporations Act*).[211] The Court of Appeal held that the proposed capital reduction at $2.78 per preference share should not be approved because it was not fair taking into account that $4 had previously been offered for the preference shares outside a takeover bid.[212]

Normally it would not be argued that a control premium would accrue to preference shares and the equality of benefits principle does not apply to most classes of preference shares. However, in the circumstances of this case, there was evidence that a control premium had in effect been paid, and the court took this into account.

Another possible reason why a minority discount should not apply to the compulsory acquisition of securities is that compulsory acquisition removes a security holder's right

[209] (1989) 15 ACLR 307, 314.
[210] Ibid.
[211] Ibid 310 (per Kirby P).
[212] Ibid 310-311 (per Kirby P) and 316 (Priestly JA).

to hold on to the securities and the ability to choose a time to sell the securities. This concept is reflected to some extent by the proposition of valuation generally under Australian law that ‘in valuing property for compensation cases, a “more liberal estimate” is made than in revenue cases.’[213] A similar concept can be found in Canadian law where some courts have awarded an ‘expropriation premium’ when valuing shares for the purpose of compulsory acquisition.[214] There is a further discussion about the Court’s ‘liberal estimate’ and ‘premiums for expropriation’ in the discussion of the cases that have considered s667C in section 4.3 below.

In relation to preference shares, which have a percentage dividend return and no voting rights, the holders of these securities would only expect the percentage return on their investment. Compulsory acquisition at market price, or on a capitalisation of dividends basis, would be appropriate in these circumstances.

The more difficult issue arises in relation to preference shares, which have some limited voting rights. In these cases a valuation would need to take into account any market premium that might attach to the securities over and above a capitalisation of dividends valuation and any evidence that a majority security holder would pay a premium for the securities. Evidence of previous purchases of securities, such as in the case of *Catto v Ampol*, might be crucial to the analysis.

Non-voting shares which have a right to participate equally with voting shares in terms of dividends, and on winding up, should arguably be subject to some minority discount as they have no means by which to control the company. It could be argued that as they do have a right to participate equally in a winding up; to compulsorily acquire at portfolio value may be perceived as imposing a penalty for the security’s lack of voting rights (taking into account the reasoning in *Cavalier Oil Corp. v Harnett*). However, as the equality of benefits principle does not apply to non-voting shares, the preferred conclusion is to apply a minority discount.

[213] *Holt v Cox* (1994) 15 ACSR 313, 336.
[214] Dennis H. Peterson, *Shareholder Remedies in Canada* (Issue 27, 1998) §4.31.1.

There appears no obvious answer to the question of whether in the valuation of options over voting shares, the underlying share price should be valued to include a minority discount. The equality of benefits principle does not apply to options. In addition people normally invest in options for the hope of speculative gain, which would suggest that a minority discount to the underlying share price should be taken into account. This argument has particular force in the case of options which cannot be exercised at the time the option is valued and out-of-the-money options. However where an option is exercisable and in-the-money at the time the option is valued, it could be argued that the company is presently liable to deliver the voting shares upon exercise. In that case, there is more strength to the argument that the valuation of the option should not take into account any minority discount to the underlying share price as an investment in such options is equivalent to an investment in the voting shares themselves.

3.3.4 Synergies and special benefits

Whether minority holders of voting shares should receive some of the synergies or special benefits under compulsory acquisition is a complex question. The discussion in sections 3.3.1 to 3.3.3 above assists to some extent in providing answers. It also assists in distinguishing between the situation where a majority security holder commences compulsory acquisition and a situation where a successful bidder who starts with less than a controlling parcel, wishes to commence compulsory acquisition.

As discussed in section 3.3.2, a majority security holder has the power to manage the company in such a way as to depress the market price of voting shares thereby acting in an arguably oppressive way. By so doing a majority security holder can in fact create potential synergy benefits. If synergy benefits were not taken into account when the majority security holder compulsorily acquired the remaining voting shares, the majority security holder would be able to benefit from previous oppressive management of the company.

Some commentators argue that these risks can be minimised by holding a diversified portfolio and selling voting shares where there is obvious oppressive behaviour. There are however some problems with this argument. It does not apply particularly well to non-listed companies. Even in relation to listed companies, it assumes that all shareholders hold a diversified portfolio.[215]

Campbell argues against this notion and bases his contention for including his various additives to the determination of fair value on the nature of shareholder consent. He argues that to infer a shareholder's consent to compulsory acquisition at a value which did not take into account any allowance for the additives referred to in section 3.1.2 (for example Information Additive or Discrete Mismanagement Additive):

> One must conclude that she (and all shareholders), in order to provide fuel for value maximising transactions, consented ex ante to a freeze-out value that impounds disinformation, mismanagement, and non-value maximising conduct on the part of their corporate managers.[216]

He therefore states that 'logic and analysis point strongly to the conclusion that investors, at least as a general matter, expect and price the basic fiduciary protections that managers are required by law to accord them'[217] and argues that Information Additive and Discrete Mismanagement Additive should be included in the value of shares for the purpose of compulsory acquisition.

Campbell also extends this argument to include Operative Saving Additive and Reasonable Management Additive.[218] Including Operative Saving Additive would cover the *Kirby* situation where the assets of the company are worth considerably more than the valuation of the company on the basis of earnings or cash flow and is therefore consistent with High Court precedent on this issue.

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[215] Rutherford B Campbell, above n 110, 137.
[216] Ibid 138.
[217] Ibid 140.
[218] Ibid 144.

Similarly Campbell argues that Labor Reduction Additive and Creditor Value Reduction Additive should be included in the determination of fair value because of the obligation on managers to 'make all moves that enhance the wealth of shareholders.'[219] While he recognises the criticism that mergers and acquisition transactions often favor the rights of shareholders over employees or creditors, he states that the courts have chosen not to extend directors' fiduciary obligations to employees or creditors.[220]

Campbell's argument for the inclusion of some of Super-Reasonable Management Additive to the determination of fair value is partly dependent on the American law but can be applied to the Australian context. He argues that shareholders would expect their managers to either come up to the standard of the finest available management or sell their shares to the finest available management.[221] In Australia, s606 (and Chapter 6 generally) of the Corporations Act prohibits holders with voting power above 20% selling their shares to another party in the absence of a takeover bid. However it is still possible for controlling shareholders to seek out potential bidders who have the finest available management to make a takeover bid for the company.

To use an old cliché, Campbell's formulation seems logical in theory, but parts of it are likely to fall down in the practice of attempting to value synergy. The case where a company is worth more on an asset basis than an earnings or cash flow basis is an easy example. There may be situations where security holders, who wish to profit from an expensive litigation exercise, will attempt to uncover speculative synergy gains. Siegel argues against including any synergy in the determination of fair value on the basis that 'valuing synergy gains is particularly speculative, requiring estimation of the future gains of an entity that was non-existent until the consummation of the appraisal-triggering transaction.'[222]

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[219] Ibid 147.
[220] Ibid 149.
[221] Ibid 144-145.
[222] Mary Siegel, 'Back to the Future: Appraisal Rights in the Twenty-First Century' (1990) 32 *Harvard Journal on Legislation* 79, 140.

While Campbell's unpacking of universal synergies is a helpful exercise in considering possible synergies, determining a value for synergies for the purposes of determining fair value of voting shares should be limited to those universal synergies that can be proven at the time of compulsory acquisition and are not speculative. Courts should attempt over time to set particular guidelines in relation to the determination of universal synergies in determining fair value. If such guidelines were in place, it is likely that Super-Reasonable Management Additive would not be included in the determination of fair value.

There is less justification for endemic or unique synergies (which are components of special benefits) to be included in the determination of fair value. Endemic or unique synergies are synergies which accrue because of the particular circumstances of the majority security holder. Santow J in *Holt v Cox* implies that in the case of compulsory acquisition it is legitimate to consider the value of the relevant securities to the purchaser.[223] However, this to some extent begs the question. Using Campbell's logic, there appears to be no reason why minority security holders should expect that a majority security holder should compulsorily acquire them at a price, which included endemic or unique synergies. While the minority security holders continue to hold their securities, endemic and unique synergies cannot be reaped even by the finest management and the majority security holder is, in the absence of oppression or to comply with some other regulation, not required to compulsorily acquire the minority security holders.

As endemic and unique synergies relate to the circumstances of the majority security holder, the minority security holders arguably have no right to participate in such benefits. Siegel argues that as they are being bought out, the minority security holders should not expect to receive endemic or unique synergies because they 'bear neither the costs nor the risks of the future enterprise and thus should not share in its rewards'.[224] It is legitimate in the case of voting shares to take into account non-speculative universal synergies, which should have been reaped prior to compulsory acquisition. However, it is

[223] (1994) 15 ACSR 313, 337.
[224] Mary Siegel, above n 222, 140.

illegitimate, from a policy point of view, to take into account possible savings, which can only be reaped from the future efforts of the majority security holder and are due to that holder's particular circumstances.

Another possible argument is that endemic synergies should at least be included. For example, savings for head office costs of a partly owned subsidiary could be reaped by all majority security holders who were companies which already had head offices of a certain size. However, there seems little reason for minority security holders to be entitled to receive these savings and it would be a difficult exercise for a valuer to attempt, which synergies were endemic and which were unique.

The issue of including synergies is quite different in the case of compulsory acquisition by a bidder, where it started with less than a controlling parcel of securities at the start of a takeover. Arguments about discouraging value-destroying behaviour on the part of majority security holders do not apply here. In addition a bidder starting from a non-controlling parcel is a participant in a market for control. There would be the risk of a counter bid by another party which may lead to the bidder paying more for the company than was originally the case. In assessing how much a bidder may want to pay for the company in the middle of a bidder war, the bidder is likely to have undertaken some due diligence and considered paying a control premium and some of the synergy value.

Arguably the price ultimately paid in such a takeover is as good a valuation of the company as any separate valuation. It is evidence as to what a legitimate third party purchaser is prepared to pay for the company and therefore is an application of the willing 'buyer and willing seller' test. American commentators have also commented on the possibility of valuing companies on this basis. Wertheimer, for example, states that:

> The common sense answer to the question 'what is an asset worth?' is 'whatever someone is willing to pay for it.' If you want to know what a home or car is worth, put it up for sale and its value will be determined. Anything short of third-party sales value is merely theoretical, or guesswork.[225]

[225] Barry M. Wertheimer, above n 151, 654. See also Michael R. Schwenk, 'Valuation problems in the appraisal remedy' (1994) 16 *Cardozo Law Review* 649, 673.

This issue in relation to valuation is important to note when considering challenges to compulsory acquisition following a takeover.

It is also important to consider whether synergy value should be taken into account in relation to classes of securities other than voting shares or interests. In the case of non-voting preference shares that provide a set dividend stream, there seems to be no reason why a valuation of these securities should involve any synergies. As the holders of these securities have no entitlement to the assets of the company, they also would have no entitlement if universal synergies could be reaped by good management. Therefore they have no legitimate expectation of receiving any synergies. In the case of non-voting shares which have equal distribution and rights, on a winding up, to voting shares, there seems to be no valid reason why the same rules relating to sharing synergy should apply.

In relation to an option over voting shares, where the option cannot presently be exercised or it is out-of-the-money, it is preferable that synergies should not be taken into account in relation to the valuation of the underlying share price. Where the option can be exercised at the time of valuation and is in-the-money, it is arguable that the underlying share price should take into account universal synergies.

3.4 How fair value is determined in Delaware

A good way of further considering the policy issues referred to above is to consider how Delaware courts have considered a provision similar to s667C in Delaware's *General Corporation Law* (*'GCL'*). The usefulness of Delaware cases is threefold. Firstly, as discussed in section 2.1, CASAC was aware of the Delaware provision when formulating a definition of fair value. Secondly, as discussed in section 3.3.2, both the majority and the minority in *Gambotto*[226] referred to one of the major Delaware cases in the valuation of shares, *Weinberger*.[227] Thirdly, cases on valuing shares for the purpose of appraisal in the United States of America are predominately cases from the Supreme Court of

[226] (1995) 182 CLR 432, 447 (Mason CJ, Brennan J, Deane J, Dawson J), 457 (McHugh J).
[227] 457 A. 2d 701 (1983).

Delaware.[228] The courts in Delaware have had considerably more experience in valuing shares, though possibly not other forms of securities, than Australian Courts. These cases, and the discussion by academic commentators of these cases, highlight the difficult issues surrounding the valuation of securities.

The Delaware provision arises in the context of appraisal rights, which apply to various mergers under the *GCL*.[229] The circumstances in which appraisal rights apply are complicated by the elaboration in the *GCL* of a 'market out' exception and exceptions to that exception. Appraisal rights as a general rule apply where:

- the relevant company has less than 2000 shareholders and is not listed on certain well known exchanges; or
- the shareholders under the merger receive as consideration something other than shares in the surviving corporation.[230]

The relevant part of subsection 262(h) of the *GCL* is referred to in section 2.1 above. The most relevant phrases in this paragraph are 'determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation' and 'the Court shall take into account all relevant factors.'

Prior to the Supreme Court of Delaware decision in *Weinberger*,[231] Delaware courts valued shares on the basis of the 'Delaware Block' method. This method applied weightings to separate valuations based on assets, earnings (capitalisation of future maintainable profits) and market value.[232] Although *Weinberger* was a case involving an alleged breach of fiduciary duty by the target board in a merger, the Supreme Court of Delaware also considered the interpretation of s262(h) of the *GCL*. The court decided

[228] Michael R. Schwenk, above n 225, 671.
[229] Paragraph 262(b) provides that appraisal rights apply to mergers or consolidations under 'Sections 251 (other than a merger effected pursuant to subsection (g) of §251), 252, 254, 257, 258, 263, or 264'.
[230] For a detailed explanation as to when appraisal rights apply, see Rodman Ward. Jr., Edward P. Welch and Andrew J. Turezyn, *Folk on the Delaware General Corporation Law* (2001) GCL-IX-177 to GCL-IX-188.
[231] 457 A.2d 701 (1983).
[232] Andrew J Turezyn, see above n 230, GCL-IX-228 to GCL-IX-237.

that 'to the extent it excludes other generally accepted techniques used in the financial community and the courts' the Delaware Block method was 'clearly outmoded'.[233]

Weinberger also considered the meaning of the phrase 'exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation':

> We take this to be a very narrow exception to the appraisal process, designed to eliminate use of *pro forma* data and projections of a speculative variety relating to the completion of the merger. But elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered. (emphasis in the original)[234]

Delaware law states that a minority discount should not apply because:

- A shareholder whose shares are to be appraised is entitled to 'his proportional interest in a going concern'.[235]
- To apply a discount would involve speculation 'on the various factors which may dictate the marketability of minority shareholdings.'
- 'To fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process.'[236]

Delaware courts, after some mistakes, have recognised the effect of various valuation methodologies in the determination of fair value.[237] There has been a recognition that a premium should be applied to a capitalisation of future maintainable profits valuation to compensate for an implied minority discount.[238] It has also been recognised that there is no minority discount implicit in a DCF valuation.[239]

Delaware courts have stated that a control premium is only to be taken into account in removing the effect of a minority discount. Therefore a control premium based on an

[233] 457 A.2d 701, 712-713 (1983).
[234] Ibid 713.
[235] *Cavalier Oil Corp v. Harnett* Del. Supr., 564 A.2d 1137, 1144 (1989), quoting from *Tri-Continental Corp. v Battye* 74 A.2d 71, 72 (1950).
[236] Ibid 1145.
[237] For a description of some of the cases where mistakes have been made, see John C. Coates, above n 104, 1280-1287, 1353-1359 and Barry W. Wertheimer above n 151, 649-652.
[238] *Borruso and Lee v Communications Telesystems International*, 753 A.2d 451, 457 (1999).
[239] *In re Radiology Associates, Inc* 611 A.2d 485, 494 (1991).

average of control premiums paid in mergers, or the application of a PER derived from comparable acquisitions to a capitalisation of future maintainable earnings valuation, is not to be taken into account as it would include 'post-merger value, such as synergies with the acquirer.'[240] However where the wholly-owned subsidiaries of a company are valued separately, the Supreme Court of Delaware in *Rapid-American Corp. v. Harris*, held that a full control premium should be taken into account in valuing these subsidiaries.[241] The Supreme Court of Delaware held that the 'exclusion of a "control premium" artificially and unrealistically treated Rapid as a minority shareholder.'[242] In a recent Supreme Court of Delaware decision, evidence of comparable transactions in the determination of a PER for a capitalisation of future maintainable earnings valuation was held to be appropriate in valuing the subsidiaries of the company.[243]

Delaware courts have also encountered difficulty over the issue of synergies. The requirement to exclude 'any element of value arising from the accomplishment or expectation of the merger or consolidation' would appear to prohibit any inclusion of special value. However it is unclear in Delaware to what extent universal synergies should be included.

In *Kirby* (referred to in section 3.2.3) the Supreme Court of Delaware held that the requirement that the shares be valued as a proportional interest in a going concern precludes a valuation approach based solely on a liquidation of the company concerned, as such a valuation technique is based on the company not continuing as a going concern.[244] Given that the company could upon liquidation be valued between US$456 and US$670 per share while the shares were appraised at US$254.40 per share, not valuing the company on the basis of liquidation value undervalued the company

[240] *Kleinwort Benson Ltd. v. Silgan Corp.* 1995 Del. Ch. LEXIS 75, *13.
[241] 603 A.2d 796 (1992).
[242] Ibid 806.
[243] *M.G. Bancorporation, Inc. v Le Beau* 737 A.2d 513, 525 (1999).
[244] 413 A.2d 137, 142 (1980).

significantly. While *Kirby* has been criticised by commentators,[245] it has been quoted with approval in subsequent Delaware decisions.[246]

However recent decisions of the Supreme Court of Delaware would appear to suggest that universal synergies should be included where they can be readily ascertained and not the subject of speculation. In *Cede & Co. v. Technicolor, Inc.*[247] ('*Cede*') MAF in November 1981 commenced a tender offer for Technicolor's shares at US$23 per share and obtained 82.19% of the total number of shares. The remaining shares were acquired in a merger transaction in December 1982. This is often described as a 'two-step merger'. Prior to the tender offer or 'first-step' Morton Kamerman, Technicolor's Chief Executive Officer and Board Chairman, decided that Technicolor should enter the business of rapid processing of computer film (One Hour Photo). Technicolor made significant losses operating this new business. After the tender offer but prior to the merger MAF's controlling stockholder, Ronald Perelman, decided to dispose of a number of Tehnicolor's less profitable businesses, including the One Hour Photo business. In valuing Technicolor's securities in an appraisal action, the Supreme Court of Delaware had to decide between a DCF valuation based on forecasts assuming that Kamerman's plans were still in operation or a DCF valuation based on forecasts assuming that Perelman's improvements had been made.[248]

The Supreme Court of Delaware held that Technicolor should be valued on the basis that Perelman's improvements had been made. The narrow reading of the exclusion of 'any element of value arising from the accomplishment or expectation of the merger or consolidation' in Weinberger was reiterated in *Cede*.[249] The Supreme Court of Delaware held that in 'a two-step merger, to the extent that value has been added following a change in majority control before cash-out, it is still value attributable to the going

[245] Rutherford B. Campbell, above n 110, 119, Barry W. Wertheimer above n 151, 662-663.
[246] *Kirby* was applied and the sole use of the orderly realisation of assets method was rejected recently by the Supreme Court of Delaware in *Paskill v Alcoma and Okeechobee* 747 A.2d 549 (2000).
[247] 684 A.2d 289 (1996).
[248] Ibid 292-294.
[249] Ibid 297 and 300.

concern.'[250] The exclusion 'does not encompass known elements of value, including those which exist on the date of the merger because of a majority acquiror's interim action in a two-step cash-out transaction.'[251]

There are likely to be situations in the Australian context where a takeover may be followed after a brief interval with compulsory acquisition under Part 6A.2, s414, a capital reduction or a scheme. Where a Court is required to determine fair value in these situations, the decision of *Cede* may be a useful example to consider.

The recent Court of Chancery of Delaware decision of *Onti, Inc. v Integra Bank* ('*Onti*')[252] shows the increasing sophistication on the part of Delaware courts on the issue of determining fair value. In *Onti*, cash out mergers were undertaken in relation to eight cancer treatment companies on 30 August 1995. In February 1996 the businesses of these eight companies were merged with a public company (EquiVision Inc.) to become a new public company (EquiMed Inc.). Consideration for the merger was shares in EquiMed.[253]

One of the valuation methods used by the expert for the minority shareholders involved a valuation of the share consideration of the later merger with EquiMed Inc taking into account the market prices of EquiMed Inc prior to the later merger ('Market Price Valuation'). The majority shareholder challenged this valuation on the grounds that:

- The President of EquiVision Inc. was adamant that he would not undertake the merger if the minority shareholders continued to hold an interest in the eight companies. The Court of Chancery of Delaware held that the evidence of the President of EquiVision contradicted this assertion.
- Section 262(h) of the GCL as well as several Delaware cases require the court to 'consider only the value of a company as it existed at the time of the merger, and not its value "in the hands of a potential acquirer, or any other value." '[254]

[250] Ibid 298.
[251] Ibid 299.
[252] 751 A.2d 904 (1999).
[253] Ibid 907.
[254] Ibid 909.

The Court of Chancery held that 'as the EquiMed Transaction was effectively in place at the time of the Cash-Out Mergers', to take it into account was 'not the product of speculation'; quoting from *Cede*.[255] In concluding that it was legitimate to take into account the value of the shares issued as a result of the EquiMed Transaction, the Court of Chancery considered the hypothetical scenario of a hypothetical company that owns a large cornfield in the middle of Manhattan:

> Let's suppose that you are the minority owner in the company that owns the cornfield and the majority stockholder and the members of the board say to themselves, boy, we really are underutilizing this asset. We ought not utilize this as a cornfield. The company is only selling at about $1 per share. We can buy it at approximately that price and subdivide it or develop it and build buildings on it and sell those buildings or rent those buildings.
>
> And the majority stockholder says to himself, yes, that's a great idea. Let's freeze out the minority. I'm going to capture all of that value for myself. And there's a freeze-out at a price that values the company by the majority stockholder at a price that reflects nothing but the value of that property as a cornfield.
>
> I would suggest to you that a valuation of that company as of the date of the merger that doesn't take into consideration the nonspeculative possibilities of developing this cornfield into something other than a cornfield is not a realistic valuation of the company. The minority shareholders, under those circumstances, are entitled to a valuation that reflects the value of a company that owns a cornfield that can be developed into a major office center.[256]

It is interesting to note that this reasoning would appear to directly contradict the reasoning in the earlier Supreme Court of Delaware decision of *Kirby*.

The Court of Chancery accepted the majority shareholder's argument that if the eight companies were to be valued by taking into account the value of the shares issued in EquiMed, then a discount should apply because these shares were issued with restrictions relating to their resale. An argument that such a discount should be offset by a control premium was rejected.[257]

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[255] Ibid 910.
[256] Ibid 910 to 911.
[257] Ibid 913 to 914.

The Court of Chancery also considered a DCF valuation of the eight companies. One of the interesting aspects of the DCF valuation in this case was that the Court of Chancery added to the discount rate a ‘small stock premium’ of 2.75%. This was based on evidence that over a period of 67 years shares in the smallest quartile of the New York Exchange listed companies had achieved higher returns that what would be expected for other shares. The inclusion of the ‘small stock premium’ was on the basis that an investor would expect a greater return on an investment in a smaller company. Its inclusion reduced the DCF valuation of the companies.

The value of the eight companies was calculated at US$25,800,000 using the Market Price Valuation and $10,034,816 using the DCF valuation. The Court of Chancery decided to give the DCF valuation twice the weight of the Market Price Valuation for the following reasons:

> As I stated above, this Court favors the discounted cash flow approach, based in large part on its wide acceptance. Furthermore, I believe it is a more accurate predictor of the value of the company, as it only considers factors affecting the Eight Centers, whereas the stock market approach may include to an unknown degree factors beyond just the Eight Centers and extending to EquiMed.
>
> The stock market valuation, being significantly higher than the DCF valuation, may take into account economies of scale, synergies and other factors not contained in the DCF valuation.[258]

The Supreme Court of Delaware has put forward the proposition that the ‘modern appraisal process presumes a sophisticated judge who exercises independence in determining the value of [a] corporation in a contested proceeding.’[259] However, as can be expected, Delaware courts have at times experienced difficulty in reconciling divergent views expressed by the experts of opposing parties. Many commentators have expressed concerns about the capacity of judges even in Delaware to determine fair value, given ‘the willingness of investment bankers and financial economists, when

[258] Ibid 925 to 926.
[259] *Gonsalves v Straight Arrow Publishers Inc.* 701 A.2d 357, 360 (1997).

acting as either advisers or expert witnesses, to tailor their opinions to the positions and interests of their clients.'[260]

These concerns have led commentators to express the view that where there is market evidence of a value of a share of the company as a whole, this evidence is to be preferred over a valuation by an expert. An example may be the case where a takeover offer has been recently made for the shares in the company.[261]

The American Law Institute's Principles of Corporate Governance has taken this concept into account in considering the preferred ambit of the appraisal remedy. It has recommended that deference should be given to 'the board's judgment with respect to arm's-length transactions, unless the circumstances provide clear and convincing evidence that the board undervalued the corporation.'[262] This conclusion is based on the business judgment rule, that normally, 'a disinterested board should be deemed superior to a court in valuation, as in other complicated business decisions'.[263] Where management is interested in the transaction, it recommended 'a valuation standard generally based on the highest price a willing, able, and fully informed buyer would realistically pay.'[264] This includes any 'proportional share in any synergy gains' unless 'such an allocation would produce a result that the court believes to be unsound, either because it would result in an undeserved windfall or because it would fail to accord with the actual contributions of the two merging firms.'[265]

This idea from the American Law Institute goes beyond the current case law from Delaware but has some similarity to the concept of special value in *Mordecai* and *Melcann*. The policy behind the American Law Institute's conclusion on the inclusion of synergy gains is that the synergy gains arise from combining the assets of the subsidiary with the assets of the holding company. Therefore as these gains would not occur

260 Michael R. Schwenk, above n 225, 679.
261 Ibid 673 and Barry M. Wertheimer, above n 151, 654.
262 The American Law Institute, see above n 99, §7.22, Comment, para (c).
263 Ibid Comment, para (d).
264 Ibid Comment, para (c).
265 Ibid Comment, para (e).

without the assets of the subsidiary being utilised, the minority shareholders of the subsidiary should share in a proportion of these synergy gains. The alternative argument is that as the synergies would not arise outside the merger and depend on the ability of the holding company to reap those synergy gains, the value of these synergy gains is best left with the holding company.[266]

There are a number of lessons for Australian Courts and policy makers, which can be gleaned from the Delaware experience. It is fairly clear that Delaware Courts have interpreted Delaware's definition of fair value in subsection 253(h) of the *GCL* to exclude unique and endemic synergies. This is not surprising given that this provision explicitly states 'exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation'. The major debate in Delaware Courts is the extent to which universal synergies can be taken into account given these words. The increasing acceptance by Delaware courts in including universal synergies provides a useful lesson for Australian Courts in ensuring that minority security holders are adequately protected. Given that CASAC considered subsection 253(h) of the *GCL* in formulating s667C and the majority and minority in *Gambotto* considered *Weinberger*, Delaware cases may prove to be useful to Australian Courts in determining fair value under s667C. The way Delaware courts have struggled to understand the effect of various valuation methodologies also provides useful lessons for Australian courts.

In addition, the struggles of Delaware courts in determining fair value and the academic discussion of the determination of fair value in the United States also provides some lessons for Australian policy makers. The increasing acceptance of the proposition that the best determination of fair value occurs in an auction for control rather than a theoretical valuation provides some guidance in determining the possible scope of s667C. This will be discussed in greater detail in Chapter 5.

[266] See Mary Siegel, above n 222, 140 as discussed in section 3.3.4.

4. Australia's statutory definition of fair value

4.1 Introduction

This Chapter commences by considering issues in the interpretation of s667C. There is an analysis of how s667C should be interpreted from first principles and also an analysis of a number of particular valuation issues in interpreting s667C including the use of ranges by experts and the valuation of securities other than voting shares. The discussion about the legislative history of s667C and Part 6A.2 in section 2.1 and the policy discussion in section 3.3 are useful for this analysis. This is followed by discussion of the cases that have considered s667C.

Some of these cases have also discussed the possible impact of s51(xxxi) of the Australian Constitution to Part 6A.2 and s667C. While it appears following these decisions, in particular Warren J's judgment in *Capricorn Diamonds*[267], that s51(xxxi) is likely to have no impact on compulsory acquisition under the *Corporations Act*, the law on this subject remains to some extent uncertain. This Chapter briefly discusses the basis for this uncertainty.

4.2 Section 667C – statutory interpretation issues

4.2.1 General

Subsection 667C(1) is reproduced below:

> To determine what is fair value for securities for the purpose of this Chapter [6A]:
>
> (a) first, assess the value of the company as a whole; and
> (b) then allocate that value among the classes of issued securities in the company (taking into account the relative financial risk, and voting and distribution rights, of the classes); and
> (c) then allocate the value of each class pro rata among the securities in that class (without allowing a premium or applying a discount for particular securities in that class).

[267] [2002] VSC 105.

On one level the meaning of the expression 'value of the company as a whole' appears fairly self-evident. A similar expression is mentioned in the English Chancery decision *Re Elgindata Ltd*:

> Should Mr and Mrs Rowland's holding be valued on a pro rata basis, according to the value of the shares in the company as a whole, or should its value be discounted to reflect the fact that it is a minority holding?[268]

Therefore in that decision the expression 'value of the shares in the company as a whole' was used to define the pro rata value of shares not taking into account any minority discount. A similar distinction is made in the United States District Court decision of *Swope v Siegel-Robert, Inc.*[269] This distinction is also consistent with the description of the expert's methodology by McLelland CJ in *Melcann*; which implies that, while the expert did not include special benefits in his valuation, he did not apply a minority discount:

> Mr Kempen valued the company as a whole at between $28.852 million and $29.843 million, which represented between $2.07 and $2.14 per share. These figures were arrived at by separately valuing the two principal areas of the company's activities namely wholesale distribution and lime production and aggregating those values with three categories of surplus assets to determine the value of the company as a whole, and proportionately the value of each of its shares.[270]

In relation to ordinary voting shares, this analysis also fits with the words of s667C(1). In valuing a company with only one class of ordinary voting shares, s667C(1) would require the expert and the Court to assess the value of the company as a whole and apply that value pro rata among the ordinary voting shares without applying a minority discount. Applying a minority discount is expressly prohibited by s667C(1)(c), as is a discount for lack of marketability.

It is not so clear from the wording in s667C(1) whether synergies or special value should be taken into account. It appears open from the words 'value of the company as a whole'

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[268] [1991] BCLC 959, 1006. The decision related to a valuation of shares for the purposes of a remedy for oppression. Warner J later held that a minority discount should be taken into account.

[269] 74 F. Supp. 2d 876, 915, 919 (2001). Like *Re Elgindata Ltd*, the United States District court held that a minority discount should apply.

to allow for valuations that include universal synergies which are not speculative. As noted in section 3.3.2 above, two High Court decisions support the proposition that a company should be valued on an orderly realisation of assets basis in cases where the earnings of the company do not reflect its true value.[271]

There is evidence from the documents referred to in section 2.1 that it was CASAC and Parliament's intention that special benefits should not be taken into account and these bodies were probably of the view that this was dealt with by s667C(1)(c). CASAC referred to the definition of fair value in Delaware's *General Corporation Law* ('*GCL*'), which excludes from the exercise of determining fair value 'any element of value arising from the accomplishment or expectation of the merger or consolidation.' The fact that Delaware cases have only included universal synergies in determining fair value is further evidence of this point. CASAC's suggestion of expressly disregarding 'whether the remaining securities of the offer class should attract a premium or discount' would appear to be an attempt to exclude special value. As noted in section 2.1, Parliament was even more blunt in stating that 'experts would not account for premiums on account of special value of the outstanding securities to the acquirer.' On first view it would appear that CASAC and Parliament made these statements with the *Melcann* decision in mind. However these statements are not entirely unambiguous. For example it is possible to argue that the statement 'premiums on account of special value of the outstanding securities to the acquirer' is limited to a premium on account of special value to the acquirer of particular securities and not any special value to the acquirer of the value of the company as a whole.

Once the company is valued as a whole and that value is allocated among the classes of issued securities, it is clear that s667C(1)(c) prohibits allowing for any special value at the point of allocating the value of 'each class pro rata among the securities in that class.' However it is not so clear that special value cannot be taken into account in valuing 'the company as a whole.'

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[270] (1995) 13 ACLC 92, 93.
[271] See fn 202.

There are at least two ways to characterise the debate over whether the expression 'value of the company as whole' should include special benefits. You could argue that question becomes whether you view the expression to mean either:

- The value of the company to the highest possible bidder, including the majority security holder. Therefore special benefits to the majority security holder would be taken into account because it forms part of the value to the majority security holder.
- The value of the company objectively to a third party purchaser, thereby excluding special benefits.

Both possibilities have some aspects of artificiality about them. The first possibility assumes that the special benefits can be easily defined and measured. The reality of the situation is that information in relation to special benefits is difficult to determine until well after the compulsory acquisition is completed. Estimates prior to compulsory acquisition are likely to be either underestimated or overestimated, depending on whether it is the majority or minority security holder undertaking the valuation.

The second possibility may be easier to value using accepted valuation techniques. However it ignores the fact that the compulsory acquirer is the same person who is to reap the special benefits. It could be argued that to ignore the value of the company to the person who is the compulsory purchaser is unrealistic. As discussed in section 3.1.3, the concept of special value arose when the courts were faced with arguments that a company was of little value to outside purchasers.

Another way of considering the question is to look at the 'value of the company as a whole' as either:

- The value of the company prior to completion of the compulsory acquisition, thereby excluding special value.
- The value of the company to the majority security holder, post the compulsory acquisition, thereby including special value.

Warren J in *Capricorn Diamonds*[272] favoured the former approach while Santow J in *Kelly-Springfield*[273] favoured the later approach.

On balance it is preferable to read the 'value of the company as a whole' in s667C(1)(a) to exclude special value. This reading, as noted above, is supported at least in part by the explanatory materials leading up to the *CLERP Act* amendments. Another argument in favour of this reading is that s667C(1)(a) should be read in the context of s667C(1) in its entirety. Paragraph s667C(1)(c) evidences an intention to exclude any special benefits at the point that the value pertaining to a particular class is allocated pro rata.

It could be argued that the expression 'value of the company as a whole' should be read in the light of comments made by the Courts on the valuation for securities for the purposes of compulsory acquisition (for example, *Melcann*). Therefore special benefits should be included. However this ignores the fact that s667C is a new provision and an attempt by the legislature to provide guidance, over and above previous Court decisions, on valuing securities. It is better to consider 'value of the company as whole' objectively as the value to a third party purchaser or alternatively the value prior to the completion of the compulsory acquisition.

This reading is also supported by the policy view, expressed in section 3.3 that special benefits are in fact the property of the majority security holder. Therefore it is appropriate from a policy point of view for special benefits not to be taken into account. In addition, because special benefits are difficult to value including them may lead to protracted litigation between majority and minority security holders.

How s667C(2) affects the determination of fair value is an interesting issue. Subsection 667C(2) requires that the purchase price for any acquisitions of securities in the relevant class in the previous six months 'must be taken into account'. However the subsection is

[272] [2002] VSC 105, [56]
[273] [2002] NSWSC 53, [71].

expressly stated not to limit the operation of s667C(1). SEK Hulme QC (Hulme) has indicated that the wording of s667C(2) is incongruous for the following reasons:

- Subsection 667(2) by its terms must limit the operation of s667(1).
- It is not easy to see how a matter dealt with in s667(2) could 'be fitted into an inquiry of the sort directed by' s667(1).[274]

However, the fact that prior market purchases of securities are at the very least an indicator of value provides some explanation for this incongruity. For example, as *Catto v Ampol* has shown, previous acquisitions may be a good indicator of the level of control premium that attaches to the value of the securities. It is an interesting question if evidence shows that previous purchases of the securities took into account some level of special value. In that case, it could be argued that the terms of s667C(1) should apply and that any special value in those previous acquisitions should not be taken into account.

4.2.2 Courts confront a range in valuation of securities provided by an expert

While many may consider valuation of securities a science rather than an art, it is difficult to argue that it is an exact science. Even if we assume philosophically that there must be one true value for securities, it is impossible in the great majority of cases for a valuer to provide anything other than an estimation of what that value is. Therefore a valuer will often provide a valuation of securities within a range. For example, it is well accepted that a discounted cash flow valuation can produce a range of values rather than one accepted figure.[275]

There has been some discussion of the question of a range of values in cases where securities have been required to be valued outside the context of compulsory acquisition. In *Hawker De Havilland v ASC*[276], the Australian Securities Commission had given relief from the takeovers prohibition for a foreign bidder in relation to its entitlement in a partly

[274] S E K Hulme AM QC, 'Section 640 of the *Corporations Law*: Independent Experts' Reports and the RTZ Ltd Takeover of Comalco Ltd' (2001) 19 *Company and Securities Law Journal* 134, 156.
[275] Samuel C. Thompson, Jr., above n 135, 499.
[276] (1991) 6 ACSR 579.

owned subsidiary of the target on the condition that the bidder also make a takeover bid for the minority shares in the subsidiary. One of the conditions of the relief was that the bidder was required to offer the minority holders a price which was ‘not less than the average of the mean of a range of values separately assessed by two independent experts, acceptable to the Australian Securities Commission’.[277] One of the many criticisms the Administrative Appeals Tribunal made of the decision was the requirement to offer a price determined by the mid point within a range provided by an expert. The Tribunal took the view that where an expert valued the shares in a range, ‘the only fair result must be the top of that range.’[278]

The Full Federal Court on appeal disagreed with the Tribunal’s view on this point.[279] Lockhart J and Hill JJ stated that:

> If the expert, rather than arriving at a single price which he considers to be fair and reasonable, provides instead a range of figures meeting that criterion (all derived from a single method of valuation), it must follow that the expert is of the opinion that each and every figure within the range is fair and reasonable. How then can it be said that the highest figure in the range produces ‘the *only* fair result’? (emphasis in the original)[280]

Lockhart J and Hill JJ concluded that common sense ‘would suggest that the fairest result would be obtained by taking an average of the values if obtained by the one method of valuation.’[281] ASIC’s current policy on downstream acquisitions adopts the Full Federal Court’s approach.[282]

The same issue has arisen in determining the value of scrip consideration in relation to the rule in s621(3) of the *Corporations Act*; that bid consideration must be at least equal to the maximum consideration that the bidder or an associate provided or agreed to provide for any bid class security during the four months before the date of the bid. In *Re*

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[277] Ibid 581.
[278] Ibid 591.
[279] *BTR v Westinghouse Brake* (1992) 106 ALR 35.
[280] Ibid 47-48.
[281] Ibid 48
[282] ASIC Policy Statement 71, [PS71.28] footnote 2.

Email Limited[283], Smorgon Distribution made a bid for Email Limited offering consideration of $1.85 cash and a convertible redeemable appliance preference share (CAP). On 30 April 2000, Smorgon had made a number of pre-bid purchases on market for prices up to $2.89 per Email share. Therefore to comply with s621(3) the value of the CAPs had to be at least $1.04 per CAP. Smorgon provided with its bidder's statement an expert report which valued the CAPs in a range between 87c and $1.21 with the mid-point at $1.04. Email argued before the Corporations and Securities Panel ('Takeovers Panel') that s621(3) dictated that the lowest point of the valuation should be adopted and therefore s621(3) had not been complied with.

In disagreeing with Email's contention, the Takeovers Panel considered the issue of where in a range of values was the true value likely to lie. The Takeovers Panel concluded that if a range of values could be characterised as a normal probability distribution that resembled a symmetrical bell curve, then the mid-point value was that most likely to resemble the true valuation of the securities.[284] This conclusion is reflected in ASIC's policy statement on s621(3).[285]

In the case of expert reports generally, ASIC states the following in Practice Note 43:

> The complex valuations in an expert's report necessarily contain significant uncertainties. Because of this an expert who gives a single point value will usually be implying spurious accuracy to his or her valuation. An expert should, however, give as narrow a range of values as possible. An expert['s] report becomes meaningless if the range of values is too wide. An expert should indicate the most probable point within the range of values if it is feasible to do so.[286]

This general statement by ASIC and the question of ranges generally have been considered by Hulme in relation an expert's determination of what is 'fair and reasonable' under s640 of the *Corporations Act*. Hulme concludes that ASIC's statement in Practice Note 43 has led experts to conclude that bid consideration anywhere within the range is to be considered fair. He is extremely critical of this practice:

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[283] (2000) 18 ACLC 708.
[284] Ibid 716.
[285] ASIC Policy Statement 163, [PS163.40] to [PS163.45].

> One can say at once that what is currently done in this area rests on the simple proposition that it is proper, in order to determine whether an offer is 'fair', to compare the offer against the figure produced when *all* factors relevant to the valuation are brought in at the possible position *least* favourable to the person whose property is to pass. And that is a proposition which quite simply cannot sensibly be supported. (emphasis in the original)[287]

Hulme refers to examples, such as valuations of residential property for rates, compulsory acquisition of land, and valuation of property for death duties, where a valuation must be given of a single figure.[288] He notes the Courts' adoption of 'a more liberal estimate' in compensation cases, as opposed to revenue cases, and surmises that in revenue cases the bottom of the range should be chosen while for compulsory acquisition cases the top of the range should be chosen.[289] In the absence of the expert's own conclusion as to where the most likely true value may be within a range, Hulme concludes that it is legitimate in an expert report under s640 to take the mid-point of a range as the determination of fairness.[290]

Hulme makes the point that 'it is not easy to see how the inquiry under' s667C(1) 'could be brought to finality without eventually arriving each time at a single figure, not a range of figures'.[291] He is right in that there must be a figure where any point lower than that figure is not fair for the purposes of s667C. The question is how should a Court determine whether consideration is fair within s667C, when faced with what it considers to be a valid valuation of securities that it expressed as a range and the consideration is somewhere within that range? A Court could approach this question in a number of ways:

(a) Assume that all values within the range are fair under s667C. Therefore the proposed consideration would be regarded as fair within s667C even if it were at the bottom of the range.

[286] ASIC Practice Note 43, [PN43.38].
[287] SEK Hulme QC, above n 274, 148.
[288] Ibid 148-149.
[289] Ibid 150.
[290] Ibid.
[291] Ibid 156.

(b) Conclude that as the matter relates to compulsory acquisition that the only fair value is at the top of the range.
(c) Assume in the absence of evidence to the contrary that the likely probability distribution of the range is a symmetrical bell curve and therefore the consideration will be fair if it is equal to or greater than the mid-point of the range.
(d) The Court determines for itself the most likely valuation within the range.

Both Santow J in *Kelly-Springfield*[292] and Warren J in *Capricorn Diamonds*[293] agreed that the requirement for Courts to adopt a 'liberal estimate' in compensation cases would suggest that a point higher in a range is more likely to be fair. Therefore the Courts are likely to adopt the approach in paragraph (d) above, with the tendency to favour a result that is the mid point or higher.

4.2.3 Valuation of securities other than voting shares

In relation to other classes of securities, an analysis of their 'relative financial risk, and voting and distribution rights', will be become crucial in their valuation. For example, in relation to preference shares with a set percentage dividend and no right to any surplus assets on a winding up, s667C(1)(b) would suggest that their allocation should be valued on a capitalisation of dividends basis. This conclusion is also consistent with Canadian authority on the subject.[294] Given the appropriateness of this valuation methodology, it seems like a waste of time for an expert to value the company as a whole. This valuation does not necessarily add to the analysis if there are no other securities to be compulsorily acquired as well. However there are no instances at this stage of ASIC modifying this requirement under s673(1).

In relation to options over voting shares, s667C(1)(b) would suggest that whether the option was presently exercisable or not and whether or not they are in-the-money may have an impact on the valuation of the options, given the words 'relative financial risk, and voting and distribution rights'. However the principles in relation to the valuation of options under s667C(1) is far from certain in the absence of authority on the subject.

[292] [2002] NSWSC 53, [72].
[293] [2002] VSC 105, [61].
[294] *Sevenway Capital Corp. v Alberta (Treasury Branches)* 2000 Alta. D. J. 136, Alta. D.J. LEXIS 189.

There have been two cases under buy out rights in s43(4) and s43(6) of the *Companies (Acquisition of Shares) Code 1981*(‘*CASA*’) which have considered the valuation of securities other than shares. These provisions are the predecessors to Division 3 of Part 6A.1 of the *Corporations Act*. These cases provide some assistance in answering the question of how to value such securities for the purposes of s667C.

In *Kingston & Anor v Keprose Pty Ltd (No2)*[295], the securities to be valued were options to acquire voting shares in Base Resources Ltd (‘Base’) with an exercise price of $1. Notice requiring the bidder to acquire the options was given on 11 March 1987. The available dates for exercise of the options were in June and December 1987.[296] Bryson J in his judgement dated 11 December 1987 stated that it was inappropriate to take into account any negative effects of the takeover when valuing the options.[297] He concluded that evidence of the terms offered under the takeover, were ‘incidentally relevant’ but not a dominant consideration, because of the ‘long interval of time’ between the closing of the takeover and acquisition of the option.[298]

Bryson J rejected the use of the Black and Scholes method of valuing options on the basis that insufficient evidence had been provided as the validity of this method. He considered that to be convinced about the use of the method would require ‘marshalling evidence of a body of transactions sufficiently large to demonstrate that market behaviour in fact conforms with predictions derived by the application of the’ Black and Scholes method. [299] It is likely that future Courts are unlikely to have the same reticence as Bryson J in accepting the Black and Scholes method as it is widely used in the financial community.[300]

[295] (1988) 6 ACLC 111.
[296] Ibid 114.
[297] Ibid 115.
[298] Ibid 117.
[299] Ibid 119.
[300] Wayne Lonergan, above n 105, 171.

Instead Bryson J considered the intrinsic value of the option, which involved valuing Base. He accepted an asset-based valuation of Base, which would mean that no minority discount was applied to the valuation of the underlying shares. In addition, Bryson J accepted evidence of a premium for shares in gold companies such as Base and added 10% to the value of the underlying shares. He added a figure for the time value of the option.[301]

In *Mercantile Mutual v Actraint*[302], the securities were:

- 'cumulative, convertible, non-redeemable preference shares of 50c, fully paid, issued at a price of $6.60;
- 'entitled to a preference cumulative dividend of 9.5 per cent per annum on the issue price of $6.70'; and
- convertible into 120 ordinary shares to every 100 preference shares 'at the holder's election on a dividend date no earlier than 31 March 1987 but prior to 31 March 1993 on which date all cumulative convertible preference shares remaining from this issue will be converted to ordinary shares'.[303]

Jacobs J agreed with Bryson J that the negative effects of the takeover on the value of the preference shares should be disregarded and concluded that therefore it would be illogical to import the takeover price into the valuation.[304] Jacobs J considered two valuation methodologies. He described the first as adding the discounted accumulated preference dividends until March 1993 with the discounted capitalised value of the expected dividends on the ordinary shares after 31 March 1993.[305] This valuation methodology would include a minority discount on the ordinary shares and would not take into account any capital gain on the ordinary shares.

The other valuation method considered by Jacobs J was 'a calculation based on the discounted value of the preferential dividend stream plus the net tangible asset backing of the shares upon conversion.'[306] He noted that one of the defendant's experts had applied

[301] (1988) 6 ACLC 111, 120.
[302] (1990) 1 ACSR 569.
[303] Ibid 571.
[304] Ibid 582.
[305] Ibid.
[306] Ibid.

a ‘write down’ to this valuation based on a minority discount and ‘deep-seated suspicion’ of the Bond group (which the bidder was a member of). While Jacobs J said that the defendant's expert had failed to satisfy him that the ‘write down’ was justified, he adopted a valuation which supported the first methodology and the second that included the ‘write down’.[307] This may at first seem as though Jacobs J had contradicted himself. However the acceptance of this figure appears to have been on the grounds that the holders of the preference shares were achieving certainty by means of this buy out right:

> I recognise that the figure of $3.90 per share which I have adopted is at the lower end of the range of values attributed by the plaintiffs to their shares, but that involves a deliberate exercise of discretion. The very uncertainty of the factors to be weighed appears to me to warrant a cautious conservatism; but in addition to that the plaintiffs, by exercising their right to have their shares acquired, exchanged the benefits of present certainty for the risks of an uncertain future, which is but a lawyer's way of saying that ‘a bird in the hand is worth two in the bush’.[308]

These cases therefore support the tentative conclusion that where securities include a presently enforceable right to an underlying voting share, it is not appropriate to include a minority discount when valuing the underlying share component of the security. However neither Bryson J nor Jacobs J stated this conclusion explicitly and it is fair to say that these cases do not provide strong authority for that proposition for future cases where securities other than voting shares are valued for the purposes of s667C. In addition in the case of *Mercantile Mutual v Actraint*, Jacobs J's rejection of the price paid for in the takeover of the ordinary voting shares constitutes a rejection of arguably what is the best evidence for the valuation of the ordinary voting shares. While it may have been justified for Bryson J to discount the amount offered under the takeover because of the period of time since the takeover closed, it is submitted that Jacobs J's rejection of the takeover price in favour of his own valuation is an undesirable precedent to be followed.

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[307] Ibid 583.
[308] Ibid 583-584.

4.3 Cases which have considered s667C(1)

4.3.1 *Goldfields Kalgoorlie 1 and 2*

This case involved an application for an injunction under s1324 challenging a capital reduction by Goldfields Kalgoorlie Ltd. The purpose of the capital reduction was that all shares held by minority shareholders be cancelled and those shareholders paid 55c per share. The company would then become a wholly owned subsidiary of the majority shareholder, Goldfields Ltd.[309]

The notice of meeting for the capital reduction contained an independent expert's report from PricewaterhouseCoopers Securities Ltd. ('PricewaterhouseCoopers'). PricewaterhouseCoopers valued:

- the Kundana and Paddington mines of Goldfields Kalgoorlie on a discounted cash flow basis;
- an additional 'option' value of $10 million 'reflecting possible incremental value that might arise if processing at Paddington could be extended' beyond its scheduled closure in 2002;[310]
- Goldfields Kalgoorlie's gold hedging book on a 'mark to market' basis;[311]
- an adoption of a valuation of Goldfields Kalgoorlie's exploration interests by Gilfillian Associates Pty. Ltd. (a firm of consulting geologists);
- an amount for head office costs, reduced taking into account rationalisation of those costs following the capital reduction; and
- a valuation of non-operating assets.[312]

PricewaterhouseCoopers concluded that the value of all the Goldfields Kalgoorlie shares on issue was between $111.7 to $114.6 million which came to a figure on a pro rata share basis of between 45.7c and 46.9c.[313] Given that the consideration under the capital reduction was 55c, PricewaterhouseCoopers concluded that the consideration was 'fair and reasonable having regard to the interests of' the minority shareholders.[314]

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[309] (2000) 34 ACSR 737, 740.
[310] PricewaterhouseCoopers Securities Limited, above n 149, 23.
[311] Ibid 35.
[312] Ibid 23
[313] Ibid.
[314] Ibid 24.

PricewaterhouseCoopers also disclosed that shares in Goldfields Kalgoorlie had traded in the year preceding the date of the report at between 50c to 82c. However PricewaterhouseCoopers decided not to take these market prices into account:

> It is usual that, for listed shares with a liquid market, day to day trading in a company's shares will be at a discount to the fair value of the shares based on a 100% interest. We consider that the observed prices for trading in GKL shares are based on a very low level of trading in the shares which means shares prices are unlikely to be representative of prices achievable for more significant interests. The thin nature of the market in GKL shares is evidenced by the wide bid/sell spread typically observed for GKL shares (for example at 8 May 2000, the bid/sell spread was 56 cents to 67 cents compared to a last sale of 58 cents).[315]

The capital reduction was challenged by Winpar Holdings Ltd. ('Winpar') on a number of grounds. For the purposes of considering the interpretation of s667C(1), the relevant issues in the case related to:

- how special benefits should be considered in determining whether the capital reduction was 'fair and reasonable to the company's shareholders as a whole' (see s256B(1)(a)); and
- whether the special benefits which accrued to the majority shareholder were adequately disclosed in the Explanatory Memorandum and expert's report (see s256C(4)).[316]

Winpar argued that all of the special benefits to be reaped under the capital reduction should have been allocated to the minority shareholders, arguing that the decision in *Melcann* supported this argument. Santow J at first instance in *Goldfield Kalgoorlie1* correctly observed that McLelland CJ had not specifically decided how the special benefits should be allocated. McLelland CJ did not need to come to this decision as he had concluded that certain special benefits had not been taken into account at all.[317]

In considering whether special benefits should be included in determining whether the consideration under a capital reduction was 'fair and reasonable to the company's shareholders as a whole' and how those special benefits should be allocated, Santow J considered the operation of s667C(1). A detailed discussion in relation to Santow J's

[315] Ibid.
[316] (2000) 34 ACSR 737, 742-743.
[317] Ibid 749.

discussion of the impact of s667C on the capital reduction provisions is in section 5.3 below. He stated that it was clear that s667C(1) 'clearly negates any requirement for other than pro rata attribution of any value of any premium in determining fair value to be paid on compulsory acquisition.'[318]

However in response to ASIC's submission that the reference to 'premium' in s667C(1)(c) included a reference to special benefits, Santow J concluded that he considered that special benefits should be taken into account in the valuation of the company as a whole under s667C(1)(a) and made the following comments in relation to s667C(1)(c):

> [68] ASIC submitted that the reference to 'premium' in s667C(1)(c) includes a reference to the 'special benefits' identified by McLelland CJ in Eq in *Melcann*, supra. It is true this premium, or reciprocal discount, may reflect particular special benefits for the acquirer in getting 100% ownership. But I consider that the references to premium (and discount) is primarily directed to the situation where a key holding *within* the acquired minority (say QBE in this present context) might command a 'premium' price to acquire; that is, absent the statutory definition in s667C of 'fair value' which precludes such circumstances in favour of a pro rata allocation of the total value including any such special benefits (s258B would likewise preclude this). In that sense, pro rata allocation of value reflected in price paid is certainly the invariable norm *within* classes where 10% or less is being acquired – or convertible securities – or convertible securities. But by parity of reasoning, the acquirer's 90% of more is not allowed to command any (notional) premium as against the minorities' 10% or less, in calculating what is paid for the minority under s667C.
>
> [69] I therefor consider that s667C in its particular context is a clear legislative indication in its context that the collective value of the company as a whole, including any special value derived from 100% ownership, is to be allocated without attributing a premium or discount to particular securities first within a class, including for example a key holding from within this minority holding compulsorily acquired and second as between majority and minority. Thus that value should be allocated pro rata, though clearly the acquirer may choose to be more generous. Thus while an expert is ordinarily required to take into account the special value 100% ownership may have to a majority holder in working out the total value of the company, fairness requires that special value to be allocated pro rata. (emphasis in the original)[319]

It is interesting to see how Santow J applied these principles to the facts of this case. One alleged special benefit was in relation to saving in head office costs. Santow J held

[318] Ibid 750.
[319] Ibid 751.

correctly that the PricewaterhouseCoopers report had taken into account head office costs. In deciding that the PricewaterhouseCoopers report had disclosed adequately the extent of these special benefits, Santow J went through the following reasoning:

> (a) The current level of head office (HO) expenses is $2m per year; para 104.
> (b) The applicable tax rate is 30%; para 104.
> (c) The level of HO expenses will be reduced by expenses that are incurred as a result of listed status of the company and will not be incurred following the selective capital reduction (SCR); para 104.
> (d) Estimated ongoing after tax HO costs following the SCR will be $0.7m; para 105.
> (e) The capitalised negative value of these costs is $4.1m; para 106.
>
> The steps that need to be taken, which are not mentioned in the [PricewaterhouseCoopers] report, are:
>
> (a) The before tax post-SCR ongoing HO expense is $1m per year ($700,000 grossed up by the 30% tax rate).
> (b) The estimated post-SCR level of HO expenses is half the current level.
> (c) The amount of HO expenses saved is $1m per year.
> (d) This has a capitalised value of $4.1m.[320]

Santow J also rightly concluded that PricewaterhouseCoopers had distributed these special benefits pro rata. In valuing Goldfields Kalgoorlie, PricewaterhouseCoopers had taken into account head office expenses assuming the capital reduction and assuming the head office costs savings could be made, as a negative capitalised figure.[321] Therefore it was incorporated in the value of Goldfields Kalgoorlie as a whole and distributed pro rata.

Santow J noted from the evidence given at the hearing that if all of the head office saving was attributed to the minority shareholders alone, this 'translates roughly at the higher end case to an increase of 13.3c per share less some 1.7c per share already attributed to the minority.'[322] This would result in a valuation at the high end of 59.3c per minority share which would have threatened PricewaterhouseCoopers fair and reasonable conclusion. However as noted above, Santow J took the view that a pro rata distribution

[320] Ibid 754.
[321] PricewaterhouseCoopers, above n 149, 23.
[322] (2000) 34 ACSR 737, 749.

of the special value among both majority and minority held shares was appropriate in this case.

It should be noted that the saving of head office costs is a special benefit as defined in section 3.1.3 above. Not all acquirers would have been able to make such a saving, particularly if the acquirer was a private individual. These savings would therefore best be characterised as endemic synergies.

There were other possible synergies alleged by Winpar that, if proved, would have been better characterised as speculative universal synergies than special value. Winpar appears to have argued that there was a possible 'economic upside' in relation to the price of gold, which should have been taken into account. Santow J was satisfied these possibilities had been adequately dealt with by the premium of 8c between the upper limit of the PricewaterhouseCoopers report and the capital reduction consideration and the fact that the upper end of the assumptions regarding gold prices (at A$500 per ounce) reflected the highest price achieved in the previous four years. Santow J noted specifically that the DCF and option valuations for the Paddington mine had been determined using the A$500 per ounce figure. He also noted that the PricewaterhouseCoopers report had assumed production at full capacity, which covered the possibility of higher production resulting from a higher gold price.[323]

He was satisfied of the adequacy of PricewaterhouseCoopers valuation of Goldfields Kalgoorlie's hedge book, noting that the valuation was consistent with the methodology detailed in Lonergan's book on valuation.[324] Santow J rejected Winpar's argument that the hedge book should have been valued on a 'mark to forecast' basis instead, as Winpar had provided no expert evidence of its own. He also noted that a higher price for gold would further depress the value of the hedge book, rather than Winpar's argument that it would have increased the hedge book's value.[325]

[323] Ibid 756.
[324] Ibid 755, referring to Wayne Lonergan, above n 105, 392.
[325] (2000) 34 ACSR 737, 755.

While Santow J's decision is extremely detailed, there are some issues where his reasoning is not unpacked. He concludes that special value should be taken into account in determining the 'value of the company as a whole', but does not provide specifically any reasons for that conclusion. There is no attempt to interpret the phrase nor is any reference made to any of the explanatory materials referred to in section 2.1. The most that can be gleaned from the judgment is that he appears to adopt the reasoning in *Melcann* in determining the meaning of the 'value of the company as a whole.' While it appears from his judgment that special benefits are over and above the value of the company to a third party purchaser, it is not entirely clear. For example Warren J in *Capricorn Diamonds* observes that Santow J 'did not appear to distinguish between the "normal" special benefit of acquiring 100 per cent control and the particular special benefit to an individual acquirer'.[326]

The other issue which may not have been argued before Santow J was whether s667C(2) should have been considered in relation to the transactions of Goldfields Kalgoorlie shares at prices above the price offered under the capital reduction. The previous market price of securities was higher than a pro rata valuation of the company as a whole, which may have included some universal synergies and special benefits.

Winpar appealed Santow J's decision on a number of grounds, including the allocation of special value. In *Goldfields Kalgoorlie2* Giles JA delivered the only substantive judgment of the Court of Appeal of the New South Wales Supreme Court, which was followed by the other justices on the point of special value.[327]

Winpar argued that Santow J had erroneously decided that the 8c difference between the expert valuation and the consideration 'went to alleviate any unfairness or unreasonableness in the allocation of special value'. Giles JA agreed with Santow J on this point.[328] Winpar also argued that Santow J should have allocated the special value wholly to the non-Goldfields shareholders. In support of that argument, Winpar quoted

[326] [2002] VSC 105.
[327] (2001) 40 ACSR 221.
[328] Ibid 249.

from a case relating to the compulsory acquisition of land by the Commonwealth, which stated that compensation must also include, ‘any additional amount which a prudent purchaser in the position of the owner….would find it worth his while to pay sooner than fail to obtain the land.’[329]

Giles JA distinguished this approach, which he characterised as the ‘vendor-purchaser’ approach, with the requirement that the capital reduction be ‘fair and reasonable to the company's shareholders as a whole.’ He noted correctly that:

> The allocation of special value was one feature only of fairness and reasonableness between the shareholders as a whole. Taken to the full, if an acquiring majority had to pay to the last cent to an acquired minority a pecuniary value for every benefit flowing from the capital reduction, there would be no reason to make the capital reduction.[330]

Giles JA distinguished *Melcann* because that case involved a finding of fact that the minority had not received any of the special value. He concluded that the pro rata allocation of special value was ‘fair and reasonable to the company's shareholders as a whole’:

> Absent the capital reduction, the non-Goldfields shareholders would not have received, through the value of their shares or otherwise, the benefit of the reduction in head office costs. By the capital reduction each of the Goldfields shareholders and the non-Goldfields shareholders stood to receive that benefit, something which they would not otherwise have received. It was in that sense, I believe, that Santow J described the special value as (part of) the normal advantages of having a wholly owned subsidiary as against partial ownership. The advantage is an advantage to the acquiring majority, but it is also an advantage to the acquired minority in that, on acquisition, they obtain an enhanced price for their shares.[331]

It was not an issue of dispute in the appeal as to whether special value should be taken into account in the first place and therefore it would not be reasonable to argue that the Court of Appeal decision is authority for the proposition that special value should be taken into account. In fact Giles JA does not state explicitly that he agreed with Santow J's view on that issue.

[329] Ibid 250, quoting from *The Commonwealth v Milledge* (1953) 90 CLR 157, 164.
[330] Ibid.
[331] Ibid.

4.3.2 *Pauls2*

This case involved an application under s664F by Pauls Limited for an order approving the acquisition of non-redeemable $2 preference shares which it did not already own in Pauls Victoria Limited ('PVL') at a price of $2.57 per share.[332] Ferrier Hodgson Corporate Advisory (Vic) Pty Ltd ('Ferriers') as expert for Pauls Limited valued the company as a whole on the following basis:

- The valuation did not include any amount of special value. Ferriers defined special value 'as the amount a specific purchaser might be prepared to pay over and above an entity's fair market value, to reflect the value to that purchaser of synergies and other benefits that might arise from acquisition of PVL.'[333]
- The valuation was based on a capitalisation of future maintainable earnings basis. Ferriers compared PVC to EBIT multiples for Burns Philp, King Island, National Foods, Ridley and SPC. Ferriers determined that the average EBIT multiple was 4.8 and was 5.6 if Burns Philp was excluded.[334] In determining a EBIT multiple of between 6.5 and 7.5[335], Ferriers took a number of matters into account, including that the multiples for the five companies above reflected 'the price payable for a minority parcel of shares'.[336] It would appear from the difference in the average EBIT multiples and the EBIT multiples Ferriers decided upon that Ferriers factored a control premium into the choice of EBIT multiple. However this is not explicitly stated in the report.

In any event the valuation of PVL as a whole has no practical significance as Ferriers valued the non-redeemable preference shares on a capitalisation of dividends basis. Ferriers described the key characteristics of the preference shares as follows:

- 'They have a face value of $2 and are fully paid'.
- 'They attract a fixed, preferential dividend of 7% or 14 cents (calculated on face value) per annum'.
- 'They are non-redeemable, ie. there are only two ways a preference shareholder can realise the capital investment made, namely:
    - By selling the preference shares.
    - In a winding-up of PVL, when the preference shareholder would receive a maximum of $2.00 per share.'[337]

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[332] (2001) 19 ACLC 959, 960.
[333] Ferrier Hodgson Corporate Advisory (Vic) Pty Ltd, *Pauls Victoria Limited, Valuation*, June 2000, 17.
[334] Ibid 21.
[335] Ibid 22.
[336] Ibid 21.
[337] Ibid 25.

In determining the capitalisation rate of between 8.5% and 9.5% Ferriers noted that:

- the current risk free rate, as represented by the 10 year Commonwealth Government Bond rate, was 6.5%;
- anecdotal evidence and recent market studies indicated that the current market premium required by equity investors was around 5% above the risk free rate;
- the risks attaching to investing in preference shares were lower than investing in ordinary share capital.[338]

Ferriers concluded by applying the 9.5% and 8.5% capitalisation rate to the preference dividend per share and an additional figure for franking credits (totalling 21.87c) to result in valuation range of between $2.30 and $2.37.

Ferriers undertook the following cross-check valuations to this analysis:

- 'The maximum amount available to preference shareholders in the event of a winding-up of the company (ie value on a orderly realisation basis) is $2 per share. This value is less than the value determined on capitalisation of dividends basis.'
- 'A valuation assuming a capitalisation rate of 6.5% (ie equal to the risk-free rate) gives a value of $3.36 on a fully franked basis'. However Ferriers noted 'that there is always some element of risk attached to shares, and hence the value of those shares, in any corporate entity.'
- 'Should the preference share dividend be paid on a wholly unfranked basis (and assuming a capitalisation rate in the range of 8.5% to 9.5%), the fair value of a PVL preference share would be in the range of $1.47 to $1.65.'[339]

Ferriers noted that a Ms Etheridge had paid $10 per preference share on 24 December 1999. Pauls Limited decided to write to Ms Etheridge on 18 January 2000 noting that the $10 per preference share value was in excess of its intrinsic value. Ms Etheridge replied by letter, which Pauls Limited received on 8 February 2000, stating amongst other matters that holders of preference shares in PVL had been 'significantly disadvantaged by the activities of the directors over the years in granting bonus issues to the ordinary share class.' Ferriers agreed with Pauls Limited's view that given the limited rights attaching to the preference shares, there was 'no link between the value of the preference shares

[338] Ibid 27.
[339] Ibid 25.

and the directors' decisions regarding bonus entitlements to ordinary shareholders'.[340] Therefore Ferriers took the view that 'the price of $10 per share is not representative of the value of the shares as a whole.'[341] Ms Etheridge lodged a notice of objection in relation to the proposed compulsory acquisition, but was not a party to these proceedings.[342]

In considering how s667C(1) applied, Douglas J had regard to the materials referred to in section 2.1. In particular he took into account the following:

- The sections from the Explanatory Memorandum to the CLERP Bill which referred to discouraging greenmailing and not 'account for premiums on account of the special value of the outstanding securities to the acquirer.'
- The Parliamentary Joint Committee on Corporations and Securities Report, which in his words indicated 'that what was being proposed (and eventually passed) was an <u>entirely new scheme</u> for the valuing of securities in cases of compulsory acquisition of shares and the like.' (emphasis in original)[343]

Douglas J noted that the respondents' main argument was that special value should be attributed to the valuation of the preference shares. He also noted the two arguments given by the applicant that special value should not be taken into account:

(a) that the legislation prescribes a method for the assessment of fair value which expressly excludes taking into account any such premium; or
(b) alternatively, if a special value should be taken into account, it should only be done in the valuation of the company as a whole. In the case of preference shares, because of their unique characteristics, none of the special value will be apportioned to the preference class shares.[344]

If Santow J's view on special benefits is to be taken to be correct, it should be noted that the applicant's second argument remains persuasive. Even if special benefits are to be taken into account in the valuation of the company as a whole, they should not be apportioned to the preference shareholders given the limited rights attached to these preference shares.

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[340] Ibid 4.
[341] Ibid 5.
[342] (2001) 19 ACLC 959, 961.
[343] Ibid 962.

Douglas J's inclination was to accept the applicant's first argument. In doing so he criticised the respondents who frequently appear in compulsory acquisition cases:

> As I have said the CLERP amendments were designed to as far as possible outlaw the concept of 'greenmailing'. Such a practice has long been the *modus operandi* of Messrs Catto and Dr and Mrs Elkington, a fact which they readily accept. In my view the valuation of these preference shares must be done in accordance with the procedures prescribed by Part 6A.2 of the Law. Therefore no question of special value arises in this case. I am fortified in this view that s667C(1)(c) uses the words in connection with the valuation 'without allowing a premium'.[345] (emphasis in the original)

Based on this conclusion, he was 'of the view that the value offered by the applicant to the respondents of $2.57 per share represents "fair value" for the remaining preference shares.'[346] Douglas J also considered Santow J's comment in paragraph 68 of his judgment in *Goldfields Kalgoorlie1* that the comment in s667C(1)(c), 'without allowing a premium or applying a discount for particular securities in that class', only applied to premiums which may attach within a class of minority securities. He disagreed with Santow J's comments regarding s667C(1), stating that they 'do not sit easily with the explanatory memorandum and the other documents' referred to earlier in his judgment.[347] Therefore it is implied that Douglas J does not agree with Santow J's proposition in paragraph 69 of *Goldfields Kalgoorlie* that special value should be taken into account in the valuation of the 'company as whole', although he does not explicitly state that.

The respondents also objected to the Ferriers report in that 'it failed to take into account the extra value to the applicant in acquiring the balance of the preference shares because of the synergies which would be obtained'.[348] Douglas J concluded that 'the evidence as to the synergies was vague, and the effect even on the best view of those synergies, would make a minimal difference to the "fair value" of the preference shares as envisaged by Part 6A.2'.[349]

[344] Ibid 963.
[345] Ibid 964.
[346] Ibid.
[347] Ibid 965.
[348] Ibid.
[349] Ibid.

Douglas J's decision is currently under appeal in the Full Court of the Supreme Court of Queensland.

4.3.3 *Kelly-Springfield*

The facts of *Kelly-Springfield*[350] were similar to those in *Pauls2*. The securities concerned were unlisted preference shares in Goodyear Australia Ltd ('Goodyear') which entitled 'their holders to a fixed cumulative preferential dividend at a rate of 8% of their paid up capital, with a right in the event of the winding up of Goodyear, to payment of capital and any arrears of dividend.' They did not 'confer any further right to participate in the profit or assets of Goodyear.'[351] The voting rights of these securities were limited to voting in relation to capital reductions, the winding up of the company, resolutions to alter the rights attaching to preferences shares or at any meetings 'where the dividend on the preference shares' had 'been in arrears for more than three calendar months prior to such a meeting.' Members of a conglomerate held all of the ordinary shares in Goodyear. Goodyear Tire & Rubber Company ('Goodyear Tyre') was the ultimate holding company of this conglomerate. Approximately 93.16% of the preference shares were held by a subsidiary of Goodyear Tyre, Kelly-Springfield Australia Pty Ltd ('Kelly-Springfield Australia'). The remaining preference shares were held by 23 other shareholders.[352]

The expert in this case, DMR Corporate Pty Ltd ('DMR'), valued the preference shares in a similar way as Ferriers did in *Pauls2*. Goodyear had made 'losses in the 1999/2000 financial year and further substantial losses in the six months to 31 December 2000.' Therefore DMR considered that a capitalisation of future maintainable profits was not an appropriate valuation methodology.[353] Goodyear had not prepared any long-term cash flow forecasts so a DCF valuation was not considered appropriate either. Neither was a

[350] [2002] NSWSC 53.
[351] Ibid [13].
[352] Ibid [11]–[12].
[353] DMR Corporate Pty Ltd, *Expert's report addressed to Mr DC Andrews, Director, Kelly-Springfield Type Company Australia Limited, 5 February 2001* 6.

valuation based on an orderly realisation of assets, as Goodyear had traded profitably until the 1999/2000 financial year. DMR settled on a net assets valuation of $93,018,000.[354]

In determining the value of the preference shares, DMR considered the dividend yield of a number of listed cumulative preference shares to derive a range of capitalisation rates of 6.29% to 7.97% with an average of 7.08%. The 16c dividend rate of the preference shares was then divided by the various capitalisation rates to produce a valuation of between $2.01 to $2.54 with an average of $2.26.[355] DMR also considered the value of the preference shares as a debt instrument by applying the interest rate of Commonwealth bonds (5.355%) to the dividend rate to value the preference shares at $2.99.[356] Given that Kelly-Springfield Australia was offering $3.00, DMR concluded that this consideration gave 'fair value for the securities concerned'.[357]

The defendant retained Wayne Lonergan as an expert to value the preference shares. He valued the preference shares as 'a secure income producing security' in a range of $2.37-$2.62 and adopted the top of that range.[358] He suggested that the special value to Kelly-Springfield Australia should be allocated 50/50 between the ordinary and preference shares.[359] He valued this special value in a range of $0.68 to $6.83, and adopted $1.37 as the 'high end of' the 'de minimus range'.[360] He also added a premium for 'forcible taking' of $1.00, a valuation of the voting rights at $0.33 and the loss of deferred tax benefits at $0.04-$0.12. He therefore valued each preference share at $4.99 rounded to $5.00.[361]

In deciding this matter, Santow J found himself in a difficult situation. Douglas J in *Pauls2* had decided in a case directly on point that special benefits should not be included

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[354] Ibid 5.
[355] Ibid 8.
[356] Ibid 9.
[357] Ibid 10.
[358] [2002] NSWSC 53, [52].
[359] Ibid [48].
[360] Ibid [52].
[361] Ibid.

in the determination of fair value under s667C. The High Court in *Australian Securities Commission v Marlborough Gold Mines Ltd* stated that the consistency in interpreting national legislation such as the *Corporations Act*, 'is a sufficiently important consideration to require that an intermediate appellate court – and all the more so a single judge – should not depart from an interpretation placed on such legislation by another Australian intermediate appellate court unless convinced that that interpretation is plainly wrong.'[362] Rogers J of the New South Wales Supreme Court in *Hamilton Island Enterprises Pty Ltd v Federal Commissioner of Taxation* expressed a similar but broader sentiment:

> In my view it is of cardinal importance in the proper administration of justice that single judges of State Supreme Courts exercising federal jurisdiction should strive for uniformity in the interpretation of Commonwealth legislation. Unless I were of the view that the decision of another judge of co-ordinate authority was clearly wrong I would follow his [or her] decision.[363]

Santow J would be aware that if he was to depart from Douglas J's conclusions on special benefits in favour of his obiter statements in *Goldfields Kalgoorlie1*, he might be liable for criticism for not promoting consistency in decision making in *Corporations Act* matters.

His first observation was that in argument before him 'much was made of what was said to be the guidance to be found in the *travaux preparatoires*' in determining the meaning of s667C (*travaux preparatoires* means 'working papers' and is an expression normally used in international law).[364] He noted that there 'has been repeated judicial cautioning against drawing general conclusions from the limited exposition possible in a second reading speech'.[365] He expressed the opinion that the 'statutory provisions themselves…proved relatively plain in meaning and relatively straightforward to interpret; indeed ironically they tend to clarify ambiguity in the supplementary materials relied upon for their construction, when it comes to the very general references therein to

362 (1993) 177 CLR 485, 492.
363 (1982) 60 FLR 285, 291-292.
364 [2002] NSWSC 53, [58].
365 Ibid [59].

inhibiting greenmailing.'[366] In relation to the views of Douglas J in *Pauls2*, he expressed the opinion that 'the degree of emphasis given to greenmailing' in Douglas J's judgment, 'may have, with respect, distracted attention from the actual clear words of s667C'.[367]

Santow J noted the statement in the Explanatory Memorandum of the *CLERP Act* that it was 'proposed that experts would not account for premiums on account of the special value of the outstanding securities to the acquirer.'[368] He was of the view that this statement did not constitute an unambiguous prohibition against taking into account special benefits in determining 'the value of the company as a whole'. Rather he believed that this concept was reflected in the draft legislative provisions in the forerunner to s667C(1)(c). Therefore he favoured the view that the draft provision and s667C were 'entirely silent about a premium referable to the added value of 100% ownership for *all* shares in toto, or for each class as a whole' (emphasis in the original).[369] In other words, Santow J interpreted the words 'special value of the outstanding securities to the acquirer' narrowly by emphasising the words 'outstanding securities to the acquirer' and thereby only excluding special benefits at the allocation stage under s667C(1)(c).

In turning to the 'unambiguous' language of s667C, Santow J noted that the guidance on valuation in the section, 'is in mandatory form but only as regards the overall sequential process.'[370] In particular he noted in relation to s667C that:

- 'There is no specific directive as to how to value the company as a whole'.
- There 'is no specific process of allocation of value between classes' as 'sub-paragraph (b) of s667C(1) uses the expression "taking into account", so as leaving room for other matters, if capable of bearing on fair allocation, also to be taken into account'.
- 'The only mandatory provision is sub-paragraph (c) preventing other than pro rata allocation within a class, and subsection (2) of s667C as regards taking into account purchases of shares in the last six months'.[371]

[366] Ibid [60].
[367] Ibid [67].
[368] Ibid [61], quoting from The Parliament of the Commonwealth of Australia, House of Representatives, above n 48, [7.45].
[369] Ibid [62].
[370] Ibid [69].
[371] Ibid.

While he considered the language of s667C to be 'relatively plain in meaning and relatively straightforward to interpret', Santow J realised that there is a question raised in interpreting the expression 'assess the value of the company as a whole':

> Is that value to be determined on the assumption that the acquisition has already taken place, or does the valuation make no such assumption?[372]

Santow J adopted a reading of 'the value of the company as a whole' that assumed that the acquisition had already taken place for three reasons.

Firstly, he argued that this reading:

> Conforms to the evident purpose of the valuation and the context in which is required. That context is one where the intended endpoint of the compulsory acquisition process is a single shareholder. This will frequently, though not inevitably, reflect itself in cost savings for the company; for example Stock Exchange listing expenses though these should not be overstated, as the Respondents did here (see para 79 below). These savings are as much benefits to the company as they are to the would-be 100% shareholder, whose shareholding will be enhanced in value thereby to the extent such savings are material. In that sense, the special value of the purchase to a particular purchaser is simply the reciprocal of the enhanced value of the company, hence my calling it reflexive value. It is clearly to be taken into account under general principle in determining fair value. Section 667C(1)(a) simply reflects that reality.[373]

Secondly he argued that the requirement under case law for a 'liberal estimate' to be applied in valuing property in compensation cases supported the inclusion of reflexive value.[374]

Thirdly, Santow J received comfort for his adoption of reflexive value from the majority of the High Court in *Gambotto v W.C.P. Limited* ('*Gambotto*'). He quoted from the following passage in *Gambotto*:

> 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

[372] Ibid [70].
[373] Ibid [71].
[374] Ibid [72].

> market value is prima facie unfair, and it would be unusual for a court to be satisfied that a price substantially above market value was not a fair value. That said, it is important to emphasize 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.[375]

Santow J in his judgment bolded the words 'and its likely future'[376] at the end of the quote and concluded as follows:

> Thus what could be more central to the nature of this corporation and its 'likely future' than that it would become 100% owned by the intended compulsory acquirer of the remaining preference shares? To the extent 100% ownership in the corporate parent would bring about consequential reflexive benefits such as cost savings and other synergies, it is part of fair value.[377]

There is a major flaw in this last part of Santow J's argument. As noted in section 3.3.2, the last sentence from the above passage of *Gambotto* is taken from the Delaware case of *Weinberger v U.O.P. Inc* ('*Weinberger*').[378] As subsection 262(h) of the *GCL*, as referred to in sections 2.1 and 3.4, excludes 'any element of value arising from the accomplishment or expectation of the merger or consolidation', the court in *Weinberger* would not have been referring to special benefits or reflexive value when it refers to 'future prospects'.[379] It is likely that the court was referring to the future prospects of the company concerned in a general sense, which could be open to all potential acquirers.

It is also drawing a long bow then to argue that the High Court in *Gambotto*, when specifically referring to *Weinberger* as the reference to the last sentence of the above quote, specifically changed the quote from 'future prospects' to 'its likely future' because it intended to pick up special benefits or reflexive value.

There are other aspects of Santow J's concept of 'reflexive value' that are worth considering. It is not clear the extent to which universal synergies are picked up in the

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375 (1995) 182 CLR 432, 447.
376 [2002] NSWSC 53.
377 Ibid [74].
378 457 A. 2d 701, 711 (1983).
379 Ibid.

concept of ‘reflexive value’. On one reading universal synergies would be within the concept of additional value that arises from the compulsory acquisition. However universal synergies are in essence a part of the value of the company prior to the compulsory acquisition taking place. For example any enhanced value of a company resulting from the value of its property rather than just its business is open to all acquirers (as discussed in section 3.3.2). Even stock exchange listing expenses, the example given by Santow J of a reflexive benefit, is a saving that is open to all acquirers of 100% of the company. Therefore it is submitted that stock exchange listing expenses should be included in the ‘value of the company as a whole’ because it an essential part of valuing the company as a whole to any 100% acquirer, not because it constitutes special benefits or reflexive value.

Santow J when referring to stock exchange listing expenses as an example, stated that these ‘savings are as much benefits to the company as they are to the would-be 100% shareholder’. In a sense Santow J was right here for the reasons described above. Saving of stock exchange listing expenses is an important part of the ‘value of the company as a whole’ to any 100% purchaser. However in relation to other aspects of reflexive value, such as savings resulting in the majority security holder being able to combine its assets with the subject company, as noted in section 3.3.4 above, there is a decent argument that such value belongs to the majority security holder rather than the company. The minority security holder does not have to share the risks of the majority security holder attempting to reap unique synergies from the merger, why should they be entitled to share in the benefits?

It is important to reiterate that Santow J expressed the view that s667C(1)(b) uses the expression ‘taking into account’ non-exhaustively because this concept influences his reasoning when considering the particular circumstances of this case. In relation to s667C(1)(b), he rejected the respondents’ argument that the preference shares held by the majority security holder constitute a separate class from the preference shares held by the minority.[380] He also noted that s667C(2) may need to be taken into account, not just as

[380] Ibid [78].

another matter to take into account in determination the allocation between classes under s667C(1)(b), but in relation to the valuation process as a whole.[381]

Santow J observed that if the consideration under s667C(1)(b) was limited to ‘the relative financial risk, and voting and distribution rights’, ‘it would be difficult to justify any allocation to the preference shares of the so-called ‘special value’ or ‘special benefit’ attributable to 100% ownership and reflected in the value of the company.’[382] He noted the limited voting rights of the preference shares and therefore was not convinced that there was any ‘proposed value to the acquiring company of not having to have regard to preference shares in any future decisions made in relation to the company.’[383] He preferred the evidence of Mr Andrews, the Finance Director of Goodyear, to Lonergan’s evidence in relation to potential cost savings. Lonergan valued these potential cost savings at $50,000 per annum, capitalised to $280,000.[384] Mr Andrews valued these savings at $5,362. Santow J noted that even if this was distributed pro rata to only the minority preference shareholders (which in any event is forbidden by s667C(1)(c)) this allocation would only yield ‘a modest 13 cents per share’, which added to Lonergan’s valuation range for ‘a secure income producing security’ was still ‘well under the offered $3 per share’.[385]

He noted that the difference in Mr Ryan’s valuation of the preference shares of $2.01 to $2.54, Lonergan’s valuation of the preference shares of $2.37 to $2.62 and the consideration of $3 provides an ‘ample margin to accommodate such portion of the special value, if any, as should be allocated to the preference shares’. In passing he made a comment concerning Mr Ryan’s valuation at $2.99 per shares as ‘a debt instrument, by reference to ten year Commonwealth Bonds’:

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[381] Ibid [81].
[382] Ibid [79].
[383] Ibid.
[384] Ibid.
[385] Ibid [80].

> After all, he was valuing what was in reality still equity albeit with ample asset cover. He might fairly have reflected that such asset cover was not as secure as having actual security, or the security represented by a promise to pay by the Commonwealth.[386]

Santow J finally concluded that there is 'no basis' for any additional special value or special benefits to be added to Mr Ryan's valuation, given 'the circumstances of his valuation with its generous upper end, itself exceeded (by one cent) in the $3 paid.[387] He left the matter open whether there may be matters other than those specifically referred to in s667C(1)(b) which may result in some special value, special benefits or reflexive value to be allocated to preference shares with similar rights to the preference shares in this case. In fact, as is discussed below, later in his judgment he seems to imply that reflexive value should be taken into account and was taken into account in this case. In addition he noted that special value or special benefits could be allocated to a class of shares, which 'share in surplus assets on a winding-up and have dividends reflecting the overall profitability of the company.' He cited ordinary shares as an example.[388]

In examining s667C(1)(c), Santow J noted that there is no scope for unequal distribution within a class of securities. He concluded therefore that in valuing securities under s667C, there needed to be a determination of the 'value of the company as a whole', which included any reflexive benefits. Then there needed to be an allocation of this value to the various classes of securities, taking 'into account the factors in' s667C(1)(b) 'and any relevant cognate factors' including the operation of s667C(2).[389]

Any allocation within a class of securities is required to be pro rata under s667C(1)(c). Therefore Santow J concluded that a premium for forcible taking could not be justified under s667C. In considering this, Santow J expressed the view that including such a premium in any event would be discriminatory to those persons who had previously sold their securities voluntarily.[390]

386 Ibid [83].
387 Ibid [84].
388 Ibid [84].
389 Ibid [86].
390 Ibid [88].

As a response to the concept of a premium for forcible taking, Santow J referred again to the general requirement for a more liberal estimate to be given in compensation cases, referring to his judgment in *Holt v Cox*.[391] He stated that:

> Such a liberal estimate for compulsory expropriation is not to require any more than what is fair within a range, though it should be on the generous side within that range of what is fair, reflecting well-settled principles applicable to expropriation generally.[392]

Near the end of his judgment, Santow J implied that reflexive value should be taken into account in valuing the preference shares. For example he states:

> Here, I am satisfied, that 'a' fair value has been provided under the terms set out in the compulsory acquisition notice. Any reflexive benefits have been fully taken into account as they should be, and the price paid has been liberally estimated within a range of what is fair value.[393]

He provided evidence of this by reiterating that even if 100% of the special benefits discovered were allocated to the minority preference shareholders this 'would not exceed in fair value terms the $3 here paid.'[394] In making that comment, he referred to Giles JA's statement in *Goldfields Kalgoorlie2* that if all the special value for a capital reduction were to be allocated to the minority, 'there would be no reason to make the capital reduction'.[395] Santow J also considered the midpoints of Lonergan's and Ryan's valuations at $2.62 and $2.50 respectively. He concluded that the 50c margin between the mid point of Ryan's valuation and the consideration 'far exceeds any conceivable allocation of any justified special benefits'.[396]

There are many questions that remain unanswered in Santow J's analysis. Santow J stated that allocation of special benefits or special value could not be taken into account under the expressed words of s667C(1)(b).[397] However he did not explain what other

[391] (1994) 15 ACSR 313, 337.
[392] [2002] NSWSC 53, [89].
[393] Ibid [90].
[394] Ibid [92].
[395] Ibid.
[396] Ibid [93].
[397] Ibid [79].

factors not explicitly stated in s667C(1)(b) would justify including such additional value. In addition, Santow J appeared to use the expressions 'reflexive value', 'special value' and 'special benefits' interchangeably without explaining whether there is any difference between any of these concepts. The definition of 'reflexive value' is on one level very clear – it relates to the additional value to the 'value of the company as a whole' that arises as a result of the compulsory acquisition. However it is not clear whether this would include any universal synergies that may be obtained as a result of the compulsory acquisition but would be open to all acquirers to obtain. It is submitted that as universal synergies are open to all acquirers, they should be included in the 'value of the company as a whole' prior to considering any additional value that can be obtained as a result of the compulsory acquisition. This is an important point to make given that Warren J in *Capricorn Diamonds* takes the opposing view to Santow J in concluding that the company concerned should be valued on the assumption that the compulsory acquisition has not taken place.

4.3.4 Capricorn Diamonds

Capricorn Diamonds has some distinguishing features in comparison to earlier cases that have considered s667C. Firstly, the securities concerned were units of a listed managed investment scheme. Capricorn Diamonds Limited, a wholly owned subsidiary of Rio Tinto Limited, and its related entities held 96.95% of the units in the Western Australian Diamond Trust ('WADT').[398] Capricorn Diamonds offered $2.00 per unit under the compulsory acquisition notice.

Secondly out of 927 unit holders in WADT, 323 unit holders, holding approximately 60 per cent of the minority units, objected to the acquisition,.[399] This is a far greater number of objectors than *Pauls2* or *Kelly-Springfield.* Thirdly, there was a large amount of expert evidence put before Warren J in this case. This led to a very detailed discussion in Warren J's judgment about valuation issues.

[398] [2002] VSC 105, [5].
[399] Ibid [7].

WADT's main assets included:

- a 5% interest in the Argyle Diamond Mines Joint Venture ('ADMJV') and through it a 5% interest in the Ellendale Project and an interest in the Argyle Diamond Mine; and
- a 5% interest in Ashton Exploration Joint Venture.[400]

Capricorn Diamonds' expert, AMC Corporate Pty Ltd ('AMC') used a variety of valuation methodologies to value WADT's assets. They valued the Argyle Diamond mine using a DCF valuation methodology.[401] The Ellendale Project was in the process of being sold to a third party, so the expert took into account the sale price.[402] Mr Stephan Meyer, a consulting geologist, valued the Ashton Exploration Joint Venture. He concluded that none of the valued exploration tenements contained an identified mineral resource, so he valued the tenements by using the Multiple of Exploration Expenditure Method.[403]

The defendants used Lonergan as their expert. Lonergan argued that:

- 'The valuation was based on an exchange rate of the Australian dollar and the US dollar that was too high'.[404]
- 'There was no allowance in the valuation for the special benefit likely to result in the compulsory acquisition of the WADT units' or any proportion of such special benefits.[405] 'Lonergan attributed a total value of special benefits in the order of $3.4M to $4.5M consisting of management cost savings of between $3.1M and $4.1M and restructuring benefits of between $0.3M and $0.4M'.[406]
- There was a 'failure to allow for cost savings'.[407]
- There was no premium for forcible taking. Lonergan estimated this premium at $1.00 per unit.[408]
- There was a 'failure to attribute a value to the voting rights of the minority' unitholders'.[409]
- There was an 'insufficient regard to the high income yield of the units'.[410]

[400] AMC Corporate Pty Ltd, *Independent Expert's Report on Western Australian Diamond Trust* (2001) 1.
[401] Ibid 28.
[402] Ibid 31.
[403] Ibid 91.
[404] [2002] VSC 105, [139].
[405] Ibid.
[406] Ibid [141].
[407] Ibid [139].
[408] Ibid [223].
[409] Ibid [139].

- There was 'insufficient allowance for the trading price of WADT units on the ASX in the preceding 12 month period'.[411] Lonergan 'relied on the fact that the highest price paid for WADT units on the ASX in the preceding six months was $2.39 per unit'.[412]

Warren J took a very different view to the *travaux preparatoires* to Santow J. She noted that s15AA of the *Acts Interpretation Act 1901* 'does not require, as a prerequisite to its operation, any ambiguity in the legislation'.[413] In considering these explanatory materials, Warren J made the general observation that 'Parliament settled upon a particular definition of fair value for the purposes of Chapter 6A of the Corporations Act because it promoted fairness and equity among all shareholders and acted to prevent the exploitation by one or a few shareholders of their minority status'.[414]

Like Douglas J, Warren J relied heavily on the explanatory material referred to in section 2.1 to justify her views.[415] In particular, Warren J referred to recommendation 14 of the *Report of the Legal Committee of CASAC on Compulsory Acquisitions*, that provided that Court appraisal 'expressly disregard whether remaining securities of the offer class should attract a premium or discount'. Warren J concluded that this 'suggests that the exclusion of premiums in s667C was intended to carry with it the exclusion of *Melcann* type special benefits'.[416] Warren J in a footnote also noted that the Legal Committee of CASAC referred to s262(h) of the *GCL* and noted that the Delaware provision would also exclude special benefits.[417]

Warren J also considered *Goldfields Kalgoorlie1* and *Goldfields Kalgoorlie2* in the course of her judgment. Warren J concluded that Giles JA in *Goldfields Kalgoorlie2*, 'did not specifically consider the application of special value in a valuation context.'[418] In any event she considered that both decisions were of limited relevance because any comments made by Santow J in relation to s667C were *obiter* and Giles JA did not

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[410] Ibid.
[411] Ibid.
[412] Ibid [143].
[413] Ibid [20].
[414] Ibid [75].
[415] Ibid [21]-[28].
[416] Ibid [75].
[417] Ibid (fn 66).

‘consider the relevance of special benefits in the context of a valuation under s667C of the *Corporations Act*’.[419]

Warren J analysed the issue of special benefits in a similar way to Santow J in *Kelly-Springfield* but came to the opposite conclusion by saying that a company should be valued prior to the completion of the compulsory acquisition:

> The defendant’s expert, Lonergan, accepted that the special benefits which he said he had identified were not part of the enterprise that was being valued. The benefits do not exist unless the transaction is consummated and do not exist until after the transaction is consummated. On that basis they cannot be part of the value of the company (here the trust) as a whole. The special benefits are external to the value of the trust and they do not exist at the time at which the value is to be established.[420]
>
> However, any special value derived from 100 per cent ownership that arises because that is the purpose of the acquisition in this case ought to be disregarded when determining the ‘value’ of the company for the purposes of s667C(1)(a). Such assessment is consistent with the long-standing common law principle, reflected in Commonwealth land acquisition legislation dating back to federation to the effect that the value of that which is acquired pursuant to a compulsory acquisition should be determined without regard to the purpose for which the acquisition occurs.[421]

Warren J correctly dismissed the concept of a premium for forcible taking:

> It is founded upon idiosyncratic features of particular unit holders not on elements of their unit. Still less is it founded on the assets or elements of the trust as a whole. The alleged premium is, in truth, compensation to a unit holder suffering divestment of the units. The content of the premium must vary according to the characteristics of the unit holder whereas those characteristics form no part of the subject-matter of the valuation addressed by s667C. The suggested premium must vary according to the characteristics of the unit holder whereas those characteristics form no part of the subject-matter of the valuation addressed in s667C. The suggested premium is akin to the solatium allowed on the occasion of compulsory acquisition of land: solatium is compensation for the distress caused by the taking. It is not part of the value of the land taken; it is a separate amount by the way of allowance for inconvenience.[422]

Warren J then enunciated a number of principles from the authorities:

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[418] Ibid [53].
[419] Ibid [54].
[420] Ibid [56].
[421] Ibid [57].

- ‘Fair value of an asset is its fair equivalent in money ascertained by a supposed sale by voluntary bargaining between vendor and purchaser, each of whom is both willing and able, but not anxious, to trade and with a full knowledge of all the circumstances which might effect value.’[423]
- ‘The fact that the units must be disposed of at fair value should not be a factor leading to a discount or lower valuation than would otherwise obtain. Conversely, it should not be a factor leading to a premium or higher valuation.’[424]
- ‘A fair value does not require that any amount should be included in respect of ransom value or power of veto’.[425]
- ‘The value of special benefits to the acquirer is not properly to be included in the calculation of the value of the company as a whole’.[426]
- ‘Generally, apart from s667C, fairness requires that the value of any special benefits should be allocated pro rata amongst securities in the same class’.[427]
- ‘If the value of special benefits is to be included under s667C, their value should be allocated pro rata under s667C’.[428]
- ‘When deciding whether the consideration is fair the proper approach is to consider whether it is fair to all shareholders, rather than whether it is fair to a particular shareholder or class of shareholders in the peculiar circumstances of the case’.[429] The market may not be a fair indication of value in circumstances or limited trading or ‘because of an effect of a takeover offer on the market’.[430]
- ‘Fair value may require a more liberal estimate of value within a range of possible values where there is a compulsory acquisition of property.[431] Nevertheless, it does not permit or require a premium for forcible taking’.[432]

Warren J considered the policy issues relating to s667C and made a number of useful observations. Warren J surmised that the concept of ‘value of the company as a whole’ was introduced into the legislation ‘in order that there might be an accommodation of the competing interests of those involved in the compulsory acquisition process’.[433] Warren J correctly observed that the concept of ‘value of the company as a whole’ prohibited any minority or marketability discounts. In addition she took the view that this concept took

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[422] Ibid [56]. The last sentence of the quote referred *to March v City of Frankston* [1969] VR 350.
[423] Ibid [59], referring to *Holt v Cox* (1994) 15 ACSR 313, 333-334, *Gregory v FCT* (1971) 123 CLR 547 and *McCathie v FCT* (1944) 69 CLR 1, 6.
[424] Ibid. The first sentence refers to *Holt v Cox* (1994) 15 ACSR 313, 336.
[425] Ibid, referring to *Edwards v Minister of Transport* [1964] 2 QB 134, 156, 158.
[426] Ibid, referring to *Pauls2* (2001) 19 ACLC 959, 965.
[427] Ibid, referring to *Goldfields Kalgoorlie1* (2000) 34 ACSR 737, 751.
[428] Ibid, referring to *Goldfields Kalgoorlie1* (2000) 34 ACSR 737, 749, 751 and *Pauls2* (2001) 19 ACLC 959, 965.
[429] Ibid [60], referring to *Elkington v Vockbay Pty Ltd* (1993) 19 ACSR 785.
[430] Ibid, referring to *Catto v Ampol* (1989) 16 NSWLR 342, *Kingston v Keprose Pty Ltd* (1988) 6 ACLC 111.
[431] Ibid [61], referring to *Commissioner of Succession Duties (SA) v Executor Trustee & Agency Co of SA Ltd (Re D Clifford)* (1947) 74 CLR 358, 373.
[432] Ibid, referring to *Holt v Cox* (1994) 15 ACSR 313, 336-337.
[433] Ibid [63].

into account 'the position of the company as an enterprise, its assets and potential revenues'.[434]

On the issue of special benefits Warren J concluded that she should adopt Douglas J's approach in *Pauls2* and 'not adopt the obiter dicta of Santow J' in *Goldfields Kalgoorlie1*.[435] She referred to the 'approach that promotes uniformity of interpretation of the *Corporations Act*' enunciated in *Australian Securities Commission v Marlborough Gold Mines Ltd*[436] and *Hamilton Island Enterprises Pty Ltd v FCT*[437] in support of her conclusion.

Warren J also considered Santow J's judgment in *Kelly-Springfield*. She examined Santow J's reliance on *Gambotto* and concluded that:

> It is apparent that the *Gambotto* principles are of no or limited application to cases such as the present because the High Court was concerned with a different statutory regime and was not constrained by the particular legislative command enshrined in s667C of the *Corporations Act*.[438]

Warren J decided not to follow *Kelly-Springfield*. She also noted that the issue of special benefits or reflexive value 'was of no consequence' in *Kelly-Springfield*, 'in the light of the price that was the subject of the compulsory acquisition'. She observed that the circumstances of *Capricorn Diamonds* are different, intimating that if special benefits or reflexive value had to be taken into account, this may have an impact on the outcome of the case.[439]

As noted above, there was a large amount of expert evidence provided to Warren J in this case. In addition to AMC, Capricorn Diamonds relied on evidence from Mr Perry of JB Were Limited and Mr Wingrove of KPMG. Mr Appleyard of AMC also provided a

[434] Ibid [64].
[435] Ibid [76].
[436] (1993) 177 CLR 485.
[437] (1982) FLR 285, 291-292.
[438] [2002] VSC 105, [83].
[439] Ibid [86].

critique of Lonergan's evidence.   Without summarising their evidence in detail, the following observations show a high degree of sophistication by these experts.

Perry gave a detailed analysis of the DCF valuation method and pointed out that 'it is generally accepted by the financial community that the DCF method is the most appropriate'.[440] In response to Lonergan's suggestion that the voting rights of the unitholders should be included, Perry suggested correctly that this would be implicitly included by 'the application of the DCF pro-rata across all units'.[441]

Wingrove's report made some very useful comments in relation to synergies:

> Valuation practitioners will typically acknowledge that certain acquirers may be able to achieve synergies and/or other benefits, however these benefits will not usually be included in the assessment of fair value on the basis of –
>
> - difficulty in estimating the synergies and/or other benefits;
> - uncertainty that a potential acquirer will be able to achieve the synergies and/or other benefits;
> - a differing level of special benefit being available to different bidders; and
> - any synergies and/or other benefits belonging more to the bidder than the target company shareholders.[442]

One aspect of this analysis by Wingrove, which is not entirely accurate, is that where an expert has valued a company on the basis of capitalisation of future maintainable profits and has determined a PER on the basis of comparable transactions, this may include some level of synergies. However Wingrove is correct in highlighting the problems of accurately determining the actual level of synergies, special benefits or reflexive value.

In considering the evidence of four experts, Warren J first had to consider the prior prices in WADT units and the operation of s667C(2). Earlier in her judgment, Warren J considered the defendants' arguments in relation to s667C(2):

> The defendants by virtue of their arguments seek to breathe into sub-s.(2) a role and operation that is not sustainable. Sub-section (2) works together with sub-s.(1). The

440 Ibid [146].
441 Ibid [166].
442 Ibid [177].

> function of sub-s.(2) is to cast light on the value of the company as a whole by having regard to the consideration paid for securities of the relevant class within the previous six month period. The sub-section does not subvert in any way the carefully formulated structure and operation of sub-s.(1) of s667C…..By virtue of the words used in sub-s.(2) the Legislature has provided other subject matter to which reference must be had in determining what is fair value.[443]

Warren J accepted the defendants' evidence that the trading of WADT units above $2.00 in the previous six months should not be taken into account because trading in the units had been thin and had been influenced by De Beers and Rio Tinto's competing bids for Ashton Mining.[444] She noted that Lonergan had 'conceded in cross-examination that trading prices do not afford a firm indication of value'[445] and considered that he had less experience than Perry on this issue.[446]

Warren J also concluded from the evidence, in a similar way to Santow J in *Kelly-Springfield*, that if Lonergan's special value was distributed pro rata and you excluded his premium for forcible taking you would arrive at a value lower than the $2.00 offered as consideration for the units.[447] Warren J agreed with Perry, Appleyard and Wingrove on the issue of exchange rates.[448] Similarly Warren J was not persuaded by Lonergan's arguments in relation to special benefits.[449] Warren J concluded by saying that 'the evidence of Lonergan was not substantiated and was contrary to normal market and valuation practice and methodology'.[450] She also observed that the evidence before her was considerably greater than the evidence before Santow J in *Kelly-Springfield*:

> In so far as I have adopted a different approach to that case with respect to special benefits or reflexive value I consider it was open to me to do so on the basis of the evidence led by the plaintiff in this case.[451]

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443 Ibid [72].
444 Ibid [192]-[196].
445 Ibid [198].
446 Ibid [199].
447 Ibid [200].
448 Ibid [204]-[211].
449 Ibid [214]-[222].
450 Ibid [231].
451 Ibid [232].

4.3.5 Conclusion

In considering the cases above, it should be noted that there are some common propositions and approaches that can be discerned.

Firstly all of the judgments are admirably pragmatic in dealing with the facts determining fair value. For example a number of judgments, when considering special benefits or reflexive value, consider whether the inclusion of these benefits pro rata would mean that the price offered is not fair, with the implication that if the offer would still be fair then the question of whether special benefits or reflexive value is included is not determinative.[452]

Secondly it is clear that fair value under s667C does not include any premium for forcible taking.[453] Thirdly if special benefits or reflexive value are to be taken into account, these benefits must be distributed pro rata within a class of securities as required under s667C(1)(c).[454] Fourthly it is appropriate to take into account the Courts' willingness to adopt a 'liberal estimate' of fair value of securities in compensation cases in considering a range of fair values provided by an expert.[455] Fifthly, the securities held by the majority security holder do not constitute a separate class from the minority just because the majority security holder holds them.[456]

As discussed in section 4.2.1 either including or excluding special benefits or reflexive value has an element of artificiality about it. If you argue that special benefits should be taken into account, you are left with attempting to estimate those benefits prior to them being reaped by the majority security holder. If you argue that special benefits should not be taken into account, you can be criticised on the basis that in valuing the company as a whole you are ignoring the value of the company to the compulsory acquirer.

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[452] *Goldfields Kalgoorlie1* (2000) 34 ACSR 737, 749, *Kelly-Springfield* [2002] NSWSC 53, [80] and *Capricorn Diamonds* [2002] VSC 105, [200].
[453] *Kelly-Springfield* [2002] NSWSC 53, [88], *Capricorn Diamonds* [2002] VSC 105, [56].
[454] *Goldfields Kalgoorlie1* (2000) 34 ACSR 737, 754.
[455] *Kelly-Springfield* [2002] NSWSC 53, [89], *Capricorn Diamonds* [2002] VSC 105, [61].
[456] Kelly-Springfield [2002] NSWSC 53, [78].

Santow J's argument in *Kelly-Springfield*[457] that including special benefits accords with the purpose of compulsory acquisition has some initial intuitive appeal. However Douglas J and Warren J's view that special benefits should not be taken into account is preferable.

For a start, even if you agree with Santow J in *Kelly-Springfield* that the explanatory material regarding s667C is not entirely clear, Douglas J and Warren J can be forgiven for thinking that there is an indication from this material that special benefits should not be taken into account. As Warren J noted in *Capricorn Diamonds*, the statement by CASAC to 'expressly disregard whether remaining securities of the offer class should attract a premium or discount', carries with it a strong implication that '*Melcann* type special benefits' are to be excluded.[458] This implication is even stronger in the Corporate Law Economic Reform Program's second report and the *Explanatory Memorandum to the CLERP Bill*, which both stated that 'experts would not account for premiums on account of the special value of the outstanding securities to the acquirer'.[459] In addition as Warren J noted, excluding special benefits is consistent with s262(h) of Delaware's *GCL* which was specifically referred to by CASAC.[460]

Wingrove's evidence in *Capricorn Diamonds* also points to another good reason why it is preferable to exclude special benefits or reflective value - these benefits are difficult to value. In addition, as discussed in section 3.3.4 above, special benefits or reflective value depend on the efforts and assets of the majority security holder. Therefore it is questionable why minority security holders should be allowed to share in any of these benefits.

One remaining issue is whether securities, which have limited voting rights or any access to the assets of the company, should receive any special benefits or reflexive value.

457 [2002] NSWSC 53, [71].
458 [2002] VSC 105, [75].
459 Department of the Treasury, Corporate Law Economic Reform Program, above n 47, 107, The Parliament of the Commonwealth of Australia, House of Representatives, above n 48, [7.45].

While Santow J conceded in *Kelly-Springfield* that allocation of special value to the preference shares would not be accordance with the express words of s667C(1)(b)[461], he was of the view that allocation under s667C(1)(b) was not limited to the express words of that paragraph. He seemed to leave the question open as to whether special benefits or reflexive value could be distributed to the preference shares. It is submitted that even if special benefits or reflexive value is to be taken into account under s667C(1)(a), these benefits should not normally be distributed to securities which have limited voting rights or access to the assets of the company. These securities are best valued on a capitalisation of dividends basis, which would also exclude any control premium.

In addition, there is some doubt about the application of s667C(2). Santow J in *Kelly-Springfield* seems to imply that s667C(2) may be a matter to take into account in the allocation process under s667C(1)(b).[462] Santow J may have had the fact scenario in *Catto v Ampol*[463] in mind when he made this comment. One way in which to determine the value of securities with limited voting rights is to consider what the majority security holder paid in the past for these securities. Santow J's argument regarding this issue is very persuasive. However it would appear that Warren J may take the view that s667C(2) has a narrower impact on s667C(1) when she says that s667C(2) 'does not subvert in any way the carefully formulated structure and operation of' s667C(1).[464] This is an issue which is likely to be clarified further when Courts are confronted with different factual circumstances.

4.4 Constitutional aspects

Paragraph 51(xxxi) of the *Australian Constitution* provides that the Commonwealth Parliament has the power 'to make laws for the peace, order, and good government of the Commonwealth with respect to:

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460 [2002] VSC 105, (fn 66).
461 [2002] NSWSC 53, [79].
462 Ibid [81].
463 (1989) 15 ACLR 307.
464 [2002] VSC 105, [72].

> (xxxi) The acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has power to make laws.

While s51(xxxi) is written in terms of a permissive power, the High Court and commentators have taken the view that it also operates as a limitation to the exercise of legislative power by the Commonwealth.[465] However there is a question, which is addressed below, as to whether it would apply to compulsory acquisition not by the Commonwealth but a private individual under another head of constitutional power.

In relation to the elements of s51(xxxi), a security can be properly characterised as a chose of action. There is recent High Court authority that reiterates the proposition that a chose of action is property for the purposes of s51(xxxi).[466] It is fairly self-evident that provisions that relate to the compulsory acquisition of securities are provisions that are made 'in respect to' the 'acquisition of property'.[467]

In relation to determining whether a provision of Commonwealth legislation provides 'just terms' to the acquisition of property, the High Court has stated that the inquiry must be 'whether the law amounts to a true attempt to provide fair and just standards of compensating or rehabilitating the individual considered as an owner of property, fair and just as between him and the government of the country.'[468]

The High Court has stated 'just terms' relates to fairness rather than compensation, 'which connotes full money equivalence'.[469] However the High Court has also observed that where the terms of acquisition depart from equivalence in value, 'this may be a strong indication that they are not fair, not just.'[470]

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[465] Peter J Hanks, *Constitutional Law in Australia*, (1991) 403 and *Bank of New South Wales v Commonwealth* (1948) 76 CLR 1, 349-350.
[466] *Smith v ANL Ltd* (2000) 75 ALJR 95, 97 (Gleeson CJ), 99 (Gaudron and Gummow JJ).
[467] For a discussion of the issue of proving that a provision of Commonwealth legislation is made 'with respect to' the 'acquisition of property', see Ibid, 114 (per Kirby J).
[468] *Grace Brothers Pty Ltd v The Commonwealth* (1946) 72 CLR 269, 290 (Dixon J). See also *Smith v ANL Ltd* (2000) 75 ALJR 95, 105 (Gaudron and Gummow JJ).
[469] *Nellungaloo Pty Ltd v The Commonwealth & Ors* (1948) 75 CLR 495, 569.
[470] *The Commonwealth of Australia v WMC Resources Limited* (1998) 194 CLR 1, 32.

The legislature has attempted to provide a 'fail safe' mechanism in relation to the constitutionality of the compulsory acquisition provisions of the *Corporations Act* in s1350 which provides that:

> (1) **[Compensation not on just terms]** If:
>
> (a) apart from this section, the operation of this Act would result in the acquisition of property from a person otherwise than on just terms; and
> (b) the acquisition would be invalid because of paragraph 51(xxxi) of the Constitution;
>
> the person who acquires the property is liable to pay compensation of a reasonable amount to the person from whom the property is acquires in respect of the acquisition.
>
> (2) **[Court may determine amount of compensation]** If the 2 people do not agree on the amount of the compensation, the person to whom compensation is payable may institute proceedings in the Court for the recovery of such reasonable amount as the court determines from the other person.
>
> (3) **[Other compensation or damages taken into account]** Any damages or compensation recovered or other remedy given in a proceeding that is commenced otherwise than under this section is to be taken into account in assessing compensation payable in a proceeding that is commenced under this section and that arises out of the same event or transaction.
>
> (4) **[Definitions]** In this section:
>
> **'acquisition of property'** has the same meaning as in paragraph 51(xxxi) of the Constitution.
>
> **'just terms'** has the same meaning as in paragraph 51(xxxi) of the Constitution.

The genesis of s1350 can be found in s1362BA of the *Corporations Law*, which was introduced by Schedule 1 of the *Company Law Review Act 1998*. The *Corporations Law* was contained in s82 of the *Corporations Act 1989*, which operated as legislation made for the government of the Australian Capital Territory and the Jervis Bay Territory. State and Territory governments enacted legislation to make the *Corporations Law* applicable as a law of and for that State or Territory.

It would appear that s1362BA of the *Corporations Law* was introduced because of concern that the High Court may alter or overturn its decision in *Teori Tau v The Commonwealth* (‘*Teori Tau*’).[471] This case established that s51(xxxi) of the *Australian Constitution* has no application with respect to Commonwealth laws made under s122 of the *Australian Constitution*, which gives the Commonwealth Parliament the power to make laws in respect of the territories.

The Courts have not so far shown a willingness to declare compulsory acquisition invalid on constitutional grounds. Douglas J considered the constitutional issue in respect to the *Corporations Law* in *Pauls v Dwyer* (‘*Pauls1*’).[472] The respondents in that case argued that the Victorian legislation which adopted the *Corporations Law* was an impermissible delegation of State power to the Commonwealth and that the acquisition of the shares was not made on just terms. Douglas J easily dismissed the first challenge and dismissed the s51(xxxi) challenge by following *Teori Tau*.

Milly Elkington appealed Douglas J’s decision in *Pauls1*. By the time the appeal was heard by the Queensland Supreme Court, the *Corporations Act* was in operation. As a result of s1384B of the *Corporations Act*, the orders made by Douglas J in *Pauls1* and *Pauls2* continued as if they were made under the *Corporations Act*. Subsection 1384(3) of the *Corporations Act* operated so that the proceedings as a whole continued as if the *Corporations Act* had always applied. Therefore while the Full Court of the Supreme Court of Queensland in *Pauls v Elkington* (‘*Pauls4*’)[473] agreed with the conclusions reached by Douglas J in first instance, they acknowledged the applicant’s view that the arguments raised were ‘irrelevant’ and ‘moot’.[474]

However, the Full Court of the Supreme Court of Queensland was informed that there would be a subsequent appeal of the constitutionality of the new *Corporations Act* and the transitional effect of s1384 in particular. McPherson JA was of the view that if this

[471] (1969) 190 CLR 564.
[472] [2000] QSC 497.
[473] (2001) 39 ACSR 397.
[474] Ibid 398 (McPherson JA).

challenge were to succeed, the question of whether the provisions of the Chapter 6A *Corporations Law* were constitutionally valid would again become relevant.[475] Williams JA took the view that in relation to any constitutional challenge based on s51(xxxi) of the Constitution, that either s1362BA of the *Corporations Law* or s1350 of the *Corporations Act* would apply:

> That provision, in my view, has the effect that if in law the acquisition must be on 'just terms' because of the provision of the Constitution, that is how the compensation payable must be assessed. In other words the legislation is not rendered invalid by the operation of s51(xxxi) of the Constitution, but rather if the provision of the Constitution applies appropriate compensation must be paid.[476]

Courts have not so far found any sympathy with the proposition that s667C does not provide fair value. Warren J in the course of an interlocutory judgment in *Austrim Nylex Ltd v Kroll & Ors*, stated that:

> In any event, I observe that s664F of the *Corporations Law* expressly provides for the payment of compensation to the persons from whom the shares are acquired. There is no basis whatsoever for the argument that the compensation there specified is other than 'just'.[477]

In *Kelly-Springfield*, Santow J also took the view that s667C constituted 'just terms' for the purposes of s51(xxxi).[478] He received some comfort by noting that while he was of the view that special benefits should be taken into account under s667C, Commonwealth land legislation which expressly excluded special benefits has been declared by the High Court to constitute just terms under s51(xxxi).[479] He was of the view that he did not need to decide on the facts the case as to whether s51(xxxi) actually was capable of application to compulsory acquisition of securities under the *Corporations Act* or the possible application of s1350.[480]

[475] Ibid.
[476] [2001] QCA 414, [22] (not reproduced in (2001) 39 ACSR 397).
[477] [2001] VSC 168, [17].
[478] [2002] NSWSC 53, [97]-[99].
[479] Ibid [97].
[480] Ibid [102].

Warren J in *Capricorn Diamonds* decided to consider whether s51(xxxi) of the *Australian Constitution* applies to compulsory acquisition under Part 6A.2 of the *Corporations Act* in event. She decided that it did not apply. She concluded that the preferable view is that compulsory acquisition under Part 6A.2 was a law that ‘merely adjusts the competing rights or claims of persons in a particular relationship or area of activity’[481] and therefore s51(xxxi) does not apply. She also noted that the extrinsic materials to the legislation ‘spell out that the principal objects of Part 6A.2 are to enhance corporate efficiency and to discourage greenmailing’. She considered that these objects are within the Commonwealth Parliament’s power under s51(xx) of the *Australian Constitution* to make laws with respect to ‘[f]oreign corporations, and trading and financial corporations formed within the limits of the Commonwealth’.[482]

Warren J also agreed with Williams JA in *Pauls4* that s1350 would apply in the event that she was proved to be wrong (in other words if s51(xxxi) applied to the *Corporations Act* and Part 6A.2 did not provide compensation on just terms).[483] There may also be a scenario where s51(xxxi) was said to apply to compulsory acquisition under the *Corporations Act* but s667C was held to constitute just terms. Under this scenario, s1350 may still provide a separate cause of action for minority security holder in other forms of compulsory acquisition, in particular schemes of arrangement. However it appears on the current cases that the application of s1350 is moot because s51(xxxi) of the *Australian Constitution* does not apply to compulsory acquisition under the *Corporations Act*.

[481] [2002] VSC 105.
[482] Ibid [118].
[483] Ibid [124].

5. The application of section 667C to methods of compulsory acquisition other than Part 6A.2

Section 667C provides that its definition of fair value applies for all of Chapter 6A. This includes the new compulsory acquisition power in Chapter 6A, buy out rights in Chapter 6A and compulsory acquisition and buy-out rights following a takeover bid.

While s667C does not apply on its terms to forms of compulsory acquisition permitted by means other than Chapter 6A, the Courts in Australia have traditionally read the provisions of the corporations legislation as a whole. In *Catto v Ampol*,[484] Kirby P considered the capital reduction provision in s123 of the *Companies (NSW) Code 1981* in the light of the protections in the *Companies (Acquisition of Shares) (NSW) Code 1981*. He made the following observation:

> The two Codes should be read together. They are addressed, substantially to the same actors. Often they operate upon the same events. Their operation is of great importance to the corporations of this country which are, in turn, of vital significance for our economic well-being. So far as the language and apparent purposes of the Codes permit, a court should endeavour to provide an interpretation of them which affords a harmonious, practical and mutually supportive operation to each.[485]

The High Court in *Gambotto* adopted a similar approach when expressing the concern that an expropriation of shares by way of an amendment to a company's constitution may circumvent 'the protection which the *Corporations Law* gives to minorities who resist compromises, amalgamations and reconstructions, schemes of arrangement and takeover offers.'[486] DeMott describes this approach as the doctrine of interdependence of statutory provisions.[487]

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[484] (1989) 15 ACLR 307.
[485] Ibid 309-310.
[486] (1995) 182 CLR 432, 446.
[487] Deborah A DeMott, above n 174, 95. She contrasts this approach with an approach where the court "could accord independent operation or equal dignity to each formally distinct mechanism." This alternative approach is used in Delaware and other states in the United States of America.

5.1 Part 6A.1 and s414 of the Corporations Act

5.1.1 Summary of the operation of Part 6A.1 and s414

Both Part 6A.1 and s414 of the *Corporations Act* have the same parentage. The forerunner to s414 was introduced as s50 of the *UK Companies Act* 1928, following the recommendations of the Green Committee.[488] The forerunner of Part 6A.2 was introduced as a result of the recommendations of the Eggleston Committee.[489]

The *CLERP Act* introduced a number of reforms to compulsory acquisition following a takeover bid in response to the CASAC report on compulsory acquisition. The following description of the operation of Part 6A.1 will focus particularly on these changes.

While the takeovers prohibition in s606 in the *Corporations Act* applies only to voting shares or voting interests in a listed managed investment scheme, a takeover bid can be made in relation to any class of securities as defined in s92(3) of the *Corporations Act*. [490] A bidder can compulsorily acquire the remaining bid class securities under Part 6A.1 if:

- the bidder is making a bid for all securities in the bid class or making a market bid;
- the bidder and their associates have relevant interests in at least 90% (by number) of securities in the bid class; and
- the bidder and their associates have acquired at least 75% (by number) of the securities that the bidder offered to acquire under the bid (whether the acquisitions happened under the bid or otherwise).[491]

If the 90% or 75% thresholds are not met, a bidder 'may compulsorily acquire securities in the bid class with the approval of the Court.'[492]

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[488] See fn 177.
[489] Commonwealth, Company Law Advisory Committee, *Report of the Standing Committee of Attorneys-General on Disclosure of Substantial Shareholdings and Takeovers* (1969).
[490] See s617 of the *Corporations Act*.
[491] Subsection 661A(1) of the *Corporations Act*. The 75% by number of remaining securities test was recommended by CASAC. For a discussion of this test and the problems with the former s701(2)(c) of the *Corporations Law*, see CASAC, above n 34, 20-31.
[492] Subsection 661A(3) of the *Corporations Act*.

If these preconditions are met and a bidder wishes to compulsorily acquire the remainder of the bid class securities, the bidder is required to acquire all the bid class securities issued or granted before the end of the offer period, in which the bidder does not have a relevant interest.[493] A bidder may also elect to acquire the following securities in the bid class in which the bidder does not have a relevant interest:

- Securities that come into existence after the end of the offer period and before the compulsory acquisition notice is given.[494]
- Securities that come into existence as a result of the exercise or conversion of rights attached to other securities, which existed at the time the compulsory acquisition is given, for a period of six weeks after the compulsory acquisition notice is given.[495]

The bidder is required to prepare, lodge with ASIC and give to the holders of bid class securities a compulsory acquisition notice under s661B of the *Corporations Act*. A holder of bid class securities can request within 1 month after the compulsory acquisition notice is given, 'a written statement of the names and addresses of everyone else the bidder has given the notice to.' The bidder must give the statement 'within 7 days after the request.' [496]

The holder of securities can apply to the Court for an order that the securities not be compulsorily acquired. The application must be made before the later of the end of one month after the bidder has given the compulsory acquisition notice or the end of 14 days after the holder is given a written statement of the names and addresses of everyone else the bidder has given the notice to.[497]

Subsection 661E(2) states that the Court may order that the securities not be compulsorily acquired 'only if the Court is satisfied that the consideration is not fair value for the securities.' Fair value is determined by reference to s667C. This subsection differs from its pre-CLERP predecessor and the present s414. Subsection 701(6) of the *Corporations*

[493] Paragraph 661A(4)(a) of the *Corporations Act*.
[494] Paragraph 661A(4)(b) of the *Corporations Act*.
[495] Paragraph 661A(4)(c) of the *Corporations Act*.
[496] Section 661D of the *Corporations Act*.
[497] Subsection 661E(1) of the *Corporations Act*.

Law stated that a Court could order that compulsory acquisition 'is not to apply in relation to the dissenting offeree'.

CASAC's suggestion that s414 be repealed, has not as yet been taken up by the legislature.[498] Compulsory acquisition under section 414 only applies to shares. Offers made under s414 are not an exception to s606. Therefore section 414 can only be used:

- in the case of non-voting shares;
- where the acquirer has voting power of 90% or more in the company; or
- in relation to an unlisted company with 50 or less members.

Section 414 operates where the 'transferee company' makes an offer relating to a scheme or contract for shares in the 'transferor company'.[499] If within 4 months of making this offer, it has been approved by 'the holders of at least nine-tenths in nominal value of the shares included in that class', the bidder may within two months after the time in which the offers have been approved by that number, give a notice to each dissenting shareholder stating that the bidder wishes to acquire the shareholder's shares.[500] This nine-tenths test excludes those shares held by the transferee company, its nominees or subsidiaries.[501] Subsection 414(5) provides that if the transferee company, its nominees or subsidiaries hold more than 10% of the total of their shares and the shares the subject of the scheme the scheme must be approved by at least three-quarters in number. Curiously there is legislative requirement that all offers must be the same in s414(5) which only applies if the transferee company, its nominees or subsidiaries hold more than 10% of the total of their shares and the shares the subject of the scheme. Therefore there is an implication that if the number of excluded shares held by the transferee company, its nominees or subsidiaries does not exceed 10%, the majority shareholder may offer different terms to shareholders.

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[498] CASAC, see above n 34, 59-61.
[499] Subsection 414(2) of the *Corporations Act*.
[500] Ibid.
[501] Definition of 'excluded shares' in s414(1) of the *Corporations Act*. This provision can be circumvented by setting up a related company to the transferee company which is not a subsidiary. It is likely that the Courts would consider such an arrangement as an artifice - Quentin Digby, above n 106, 112.

The rights of dissenting shareholders in s414 are similar to the rights under the pre-CLERP s701 of the *Corporations Law*. Subsection 414(3) states that upon sending out notices under s414(2), the transferee company is entitled and bound to acquire the remaining offerees' shares, 'unless the Court orders otherwise on an application by a dissenting shareholder made within one month after the day on which the notice is given or within 14 days after a statement is supplied under subsection (7) to a dissenting shareholder.'

5.1.2 Pre-CLERP Act challenges to compulsory acquisition

The case law on challenges to compulsory acquisition under s414 and s701 of the *Corporations Law* put greater weight on the number of shareholders accepting offers rather than on issues of fairness of the price offered. In *Blue Metal Industries Ltd v Dilley*, the Privy Council contended that a forerunner of s414 was 'essentially a structural section' where 'once a company has become so nearly a total owner, or parent, of another company as a shareholding of ninety per cent would represent, it should not be prevented from converting the other company into a wholly owned subsidiary by so small a dissenting minority as ten per cent or less but should be entitled to acquire the holding of that minority.'[502]

Maugham J established in *Re Hoare & Co Ltd* that the onus was on the applicant to 'affirmatively establish that, notwithstanding the views of a very large majority of shareholders the scheme is unfair.'[503] Rowland J goes further in *Eddy v WR Carpenter Holdings Ltd*, saying that the evidentiary burden on the applicant 'will be greater where it is in fact that the offeror has already received acceptances from a large proportion of shareholders holding a large proportion of the issued capital.'[504] Buckley J gave a policy rationale for this approach in *Re Bugle Press*, stating that the courts will not disturb the conclusion taken by the majority of shareholders because, 'the court is accustomed to pay

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[502] (1969) 117 CLR 651, 658. See also *Elkington v Shell Australia Ltd* (1993) 11 ACSR 583, 585 (Kirby ACJ), 590 (Sheller JA).
[503] (1933) 150 LT 374, 375.
[504] (1985) 10 ACLR 316, 318.

the greatest attention to what commercial people who are concerned with the transaction in fact decide.'[505]

There is evidence that even when a bid was made by a majority holder, the courts allowed for compulsory acquisition to occur even if there was evidence that the price offered under the bid was not a fair price as defined in s667C. In *Re Greirson Oldham & Adams Ltd*, Plowman J took the view that 'it is not unfair to offer a minority shareholder the value of what he possesses, i.e., a minority shareholding.'[506] In *Eddy v WR Carpenter Holdings Ltd* the dissenting shareholder argued that the price offered did not take into account a control premium. Rowland J simply noted that as control had already passed before the takeover, this contention failed.[507]

Therefore prior to the *CLERP Act* amendments, a minority shareholder facing a takeover by a majority shareholder could not be guaranteed to receive a value which was fair under s667C, even if the minority shareholder chose to challenge compulsory acquisition following the bid.

5.1.3 Challenges to compulsory acquisition under Part 6A.1 and the meaning of 'fair and reasonable'

As noted in section 2.1, the Business Law Council of Australia expressed the concern that the *Gambotto* decision may lead to reversing the onus on dissidents under s414 and s710 and introduce additional disclosure obligations in s701. As a result, s661E(2) provides that the 'Court may order that the securities not be compulsorily acquired under subsection 661A(1) only if the Court is satisfied that the consideration is not fair value for the securities.'

The irony behind this innovation is that there now is a greater scope for dissenting security holders to argue that compulsory acquisition should not apply to their securities

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[505] [1961] 1 Ch. 270, 277.
[506] [1968] 1 Ch. 17, 35.
[507] (1985) 10 ACLR 316, 320.

because the consideration is not fair. In addition, there is a potential for expert reports commissioned by the target to be used as ammunition in such challenges.

Section 640 of the *Corporations Act* provides that in the following circumstances a target statement must be accompanied by an independent expert's report 'that states whether, in the expert's opinion, the takeover offers are fair and reasonable and give reasons for forming that opinion':

- The bidder's voting power in the target is 30% or more.
- The bidder is a director of the target (where the bidder is an individual).
- A director of the bidder is a director of the target.

This provision was first introduced as s23 of *CASA*. The Explanatory Memorandum for the *Companies (Acquisition of Shares) Bill 1981* (Cth) ('*CASA*') stated the following as the rationale for the provision:

> This provision will prevent the recurrence of situations where an offeror after gaining control of the offeree, makes a further and lower offer to minority shareholders, thus giving rise to an understandable skepticism in relation to recommendations in Part B statements [the former name for target statements], notwithstanding any assurances given that the common directors have taken no part in the deliberations prior to the second offer being recommended. A similar requirement was included in the European Economic Community Third Draft Directive on Company Law (chapter 2 – article 5) prepared in 1970, but not yet adopted by the E.E.C. It is a requirement of the London City Code on Take-overs and Mergers that the board of an offeree company must obtain competent independent advice on any offer (not only offers from companies with a substantial holding in the offeree or common directorships), and the substance of such advice must be made known to the shareholders.[508]

Section 640 is therefore designed to ensure an appropriate level of disclosure of the fairness and reasonableness of the takeover bid is provided to target security holders in cases where a bidder already has some level of control of the target. It leaves open the possibility that the minority target security holders can accept a bid even when the bid is clearly not fair as defined in s667C.

[508] Commonwealth, *Explanatory Memorandum, Companies (Acquisition of Shares) Bill* (1980) [84].

ASIC's view on the meaning of 'fair and reasonable' in s640 can be found in Policy Statement 75 ('PS 75'). PS 75 states that 'an offer is "fair" if the value of the offer price or consideration is equal to or greater than the value of the securities the subject of the offer.'[509] In determining whether the offer is fair, PS 75 states the following:

> [PS 75.27] This comparison must be made assuming 100% ownership of the target company. In his or her opinion on the fairness of an offer, the expert should not consider the percentage holding of the offeror or its associates in the target company.
>
> [PS 75.28] In assessing the comparative values of the consideration and the securities which are the subject of the offer, the expert should not take into consideration the percentage holding of the offeror or its associates in the target company.[510]

A simpler way of expressing these paragraphs is that a minority discount should not be applied in assessing whether an offer is 'fair'.

The most contentious part of PS 75 is the statement that, while an offer is 'reasonable' if it is fair, an offer 'may also be "reasonable" if, despite not being "fair" but after considering other significant factors, shareholders should accept the offer in the absence of any higher bid before the close of the offer.'[511] The policy statement states that a bidder's 'pre-existing entitlement to shares in the target' is a relevant factor to take into account in determining whether an offer is reasonable even if it is not fair.[512] PS 75 was issued first by the Australian Securities Commission (as ASIC was then named) on 8 December 1993. It superceded National Companies and Securities Commission ("NCSC") Release 102. NCSC Release 102 did not specifically come to the conclusion that an offer could be 'reasonable' even if it was not 'fair'. However it did intimate that in determining whether a takeover bid was 'reasonable', the bidder's 'pre-existing entitlement to shares in the target' could be taken into account.[513]

PS 75 has been criticised by the Courts. In *Re Rancoo Ltd*, Hayne J in the context of approving a capital reduction under s195 of the *Corporations Law*, stated that:

[509] ASIC Policy Statement 75, [PS 75.26].
[510] Ibid [PS 75.27] and [PS 75.28].
[511] Ibid [PS 75.29].
[512] Ibid [PS 75.31].

> I find the proposition that an offer may be 'not fair' and yet still 'reasonable' one which presents some difficulty. Perhaps that view stems from the impression I have that the expression 'fair and reasonable' is but a single expression intended to convey a single overall meaning which is not to be identified by reference to particular constituent elements.[514]

Later in his judgment, Hayne J added:

> Again, it would seem to me that to divide the expression 'fair and reasonable' as the policy statement would have it, is to invite the expert to engage upon a task which requires consideration, in the first case, of circumstances that may be divorced to some extent from those which in fact obtain, while at the same time requiring that expert, later, to give an overall assessment of the worth of the proposal. Perhaps an approach of the kind described in PS 75 is useful in connection with the particular provisions of the law which are mentioned in it. I need express no view about that. It is enough to say that I doubt that it is an approach that is particularly helpful in connection with a reduction of capital. Indeed in some cases it may obscure more than it illuminates.[515]

The Full Court of the Supreme Court of South Australia in *Duke Group Ltd (in liq) v Pilmer and Others*, stated that they shared Hayne J's doubts about the validity of the distinction drawn in PS 75 between 'fair' and 'reasonable' in the context of s640.[516]

Commentators are also critical of ASIC's approach to the meaning of 'fair and reasonable'.[517] Hulme notes that there are a number of decisions which interpreted phrases such as 'fair and reasonable' as a compound phrase.[518] In addition he notes numerous decisions, which use the words 'fair' and 'reasonable' interchangeably.[519]

Hulme is particularly concerned about the conclusion that an offer which is otherwise 'fair' may be 'reasonable' because of the absence of a higher offer, with the implication that this situation may arise where the bidder already has control of the target.[520] He

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513 NCSC Release 102, [20(b)].
514 (1995) 17 ACSR 206, 208.
515 Ibid 209.
516 (1999) 31 ACSR 213, 268 (Doyle CJ, Duggan and Bleby JJ).
517 SEK Hulme QC, above n 274 and Alberto Colla, 'Eliminating Minority Shareholdings – Recent Developments' (2001) 19 *Company and Securities Law Journal* 7, 16.
518 S E K Hulme AM QC, above n 274, 140.
519 Ibid 139-140.
520 Ibid 151-152.

argues that while it may be sensible to accept the offer in these circumstances, the offers do not become ‘reasonable’ as a result of these circumstances. He is of the view that the phrases ‘fair and reasonable’ and ‘fair value’ are synonymous.[521]

Hulme argues that a conclusion by an expert that a bid is not fair and not reasonable has considerable ‘moral force’, would be commented upon publicly and may ‘stiffen the resolve of target shareholders to resist the offers until they are improved.’[522] This leads Hulme to the strongly worded opinion that ASIC’s policy on the meaning of fair and reasonable has ‘cost shareholders in target companies billions of dollars’ and ‘may been seen as little short of a national tragedy.’[523]

Hulme’s comments on the overall effect on the economy of ASIC’s policy may be overstated. However he is right in pointing out that, where an expert has concluded that the consideration under the bid is not fair and the bid consideration is not improved upon, the bidder runs the risk of a Court order that an applicant’s securities under the bid not be compulsorily acquired under s661E(2).[524]

One of the issues a Court will need to consider when faced with an expert’s report stating that the bid consideration is not fair is whether the expert’s methodology is consistent with s667C. Expert reports which follow the methodology in PS 75 are often used by targets even where s640 does not strictly apply. As experts are engaged by the target board, there is a risk that such reports may overstate the value of the company concerned. There is also an issue of choice of valuation method. In some cases an expert may value the company on a capitalisation of future maintainable earnings basis with a PER based on comparable transactions.[525] As noted in section 3.2.2 above such a valuation methodology may include unique or endemic synergies which on one reading are excluded from the determination of fair value under s667C.

[521] Ibid 158
[522] Ibid 136.
[523] Ibid 136-137.
[524] Ibid 158.
[525] For example see Grant Samuel & Associates Pty Ltd, *Independent Expert’s Report for Pioneer International Limited* (2000) 54-59.

ASIC's views on the expression 'fair and reasonable' would appear to be based on pragmatism rather than legal nicety. It is implicit from the comments in PS 75 on the meaning of 'fair and reasonable' that security holders may need to take into account the fact that the bidder already has control of the company in making a decision whether to accept a bid which is otherwise not fair. As Merkel J observed in *ASIC v Yandal Gold Pty Ltd*, 'a bidder for a company is under no obligation to offer what it considers to be a fair price'.[526] There is an assumption that a minority security holder's choices might be limited. This assumption has now been challenged by the combined effect of s661E(2) and s667C. A minority security holder now has the option to challenge compulsory acquisition on the basis that the consideration offered under the bid is not fair.

However, where a bidder does not commence a bid with control of the target, there is either the possibility or the reality of rival bidders. As discussed in sections 3.3.4 and 3.4 above, there is an argument that a competitive market for corporate control is likely to produce a fair value of the company as a whole. In these cases Courts are well advised to question an independent expert's report that concludes that the takeover consideration is not fair. Subsection 667C(2) may be of use by Courts in taking the view that evidence of the bid price should be taken into account in determining fair value under s667C. Alternatively s661E(2), in using the word 'may', appears to give the Court the discretion to not make an order under that section in the instance where the Court is otherwise satisfied that the consideration is not fair value for the securities.

5.1.4 Specific valuation issues in Part 6A.1

Unlike compulsory acquisition under Part 6A.2, a Court considering the issue of fair value for the purposes of s661E(2) may need to consider the value of scrip consideration under the takeover bid. In the case of shares consideration target security holders are likely to receive only a minority interest in the bidder. Therefore it is appropriate for the Court to value the share consideration in a way which includes a minority discount. This can be achieved by either averaging prices of the shares on the stock exchange or a capitalisation of future maintainable earnings valuation with a market based PER. Some valuation issues may arise in taking into account the effect of the acquisition of the target on the bidder's share price.

Subsection 661E(2), like s664F(3), is written in the present tense. Therefore it could be argued that the valuation under s661E(2) should be undertaken at the time of the Court hearing. However different policy considerations apply in the case of s661E(2) compared to s664F(3). An action under s661E(2) only concerns those security holders who have applied to the Court under s661E. Therefore there is scope under the Court's general jurisdiction under s661E(2) to decline to make an order that the securities not be compulsorily acquired. This would apply where the consideration under the bid provided a fair value for the securities at the time of the issue of the compulsory acquisition notice.

5.1.5 Disclosure in bidders' statements

There are two possible ways in which disclosure of synergies or special value could be required in a bidders' statement. In the case of a bid offering shares as consideration, there may be a requirement that the bidder's statement contain 'all material that would be required for a prospectus for an offer of those securities by the bidder under section 710 to 713'.[527] This is on the basis that the synergies or special value which may be reaped by the bidder may affect the price of the shares offered under the bid.

In relation to all bids, paragraph 636(1)(m) may apply. Paragraph 636(1)(m) requires disclosure of all other information that is known to the bidder, does not relate to the value of securities offered as consideration under the bid, and is material to the making of the decision by a target security holder whether or not to accept the bid. There is conflicting case law on the issue of whether s636(1)(m) requires disclosure of synergies or special

[526] (1999) 32 ACSR 317, 347-348.
[527] Paragraph 636(1)(g).

value.[528] Renard and Santamaria have attempted to reconcile these cases by arguing 'if the bidder is aware of some facts which are not publicly available and would, if known, indicate that the acquisition is of significant potential benefit to the bidder, those facts are "information" which must be disclosed'.[529]

If the view is taken that fair value under s667C should include special benefits, it could be argued that there should be disclosure of special benefits in the bidder's statement as this will assist potential dissenting security holders in deciding whether or not to challenge compulsory acquisition of their securities. In any event disclosure of special benefits is arguably relevant to a target security holder's assessment as to whether to accept or reject the bid.

5.1.6 Challenges to compulsory acquisition under s414

Subsection 414(3) provides that upon sending out notices under s414(2), the bidder is entitled and bound to acquire the remaining offerees' shares, 'unless the Court orders otherwise on an application by a dissenting shareholder.' The scope of the Courts' power to 'otherwise order' is uncertain. In *Re Deans*, Hardy Boys J of the New Zealand High Court held that the power to 'otherwise order' certainly appeared 'to enable the Court to do more than simply allow or disallow the objection.'[530] There would appear to be instances where the courts have declared that the majority shareholder was not entitled or bound to acquire all of the outstanding shares.[531] It is also debatable whether a court could order compulsory acquisition for the applicant's shares for a different price.[532]

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[528] *Aberfoyle Ltd v Western Metals Ltd* (1998) 28 ACSR 187, 210, *Pancontinental Mining Ltd v Goldfields Ltd* (1995) 16 ACSR 463, 467.
[529] Ian Renard and Joseph Santamaria, *Takeovers and Reconstructions in Australia* (Service 36, April 2002) [817].
[530] [1986] 2 NZLR 271, 278.
[531] *Esso Standard (Inter-America) Inc. v JW Enterprises Inc.* (1963) 37 DLR (2d) 598, 601, 606 and *Re Bugle Press Ltd* [1961] 1 Ch. 270, 278. This conclusion appears to be open on a plain reading of s414(3). However the only Australian case to order otherwise only ordered that the compulsory acquisition did not apply to the applicants – *Re Rees Application* [1972] QWN 110, 113.
[532] See Renard & Santamaria, above n 529, [1223].

It is likely that the Courts would apply the *Catto v Ampol* principle to challenges to compulsory acquisition under s414. This would result in all offers under s414 requiring to be on the same terms and the application of s667C principles in determining fairness in Court challenges.

5.2 Buy-out rights under Parts 6A.1 and 6A.2

Division 2 of Part 6A.1 requires bidders, who with their associates have at least 90% of the bid class securities after the bid, to offer to buy out the remaining bid class security holders on the same terms which applied under the bid. While it is not made explicit in these provisions, it would seem reasonable to assume that a bidder does not have to comply with these provisions if it has already dispatched a compulsory acquisition notice under s661B.

Division 3 of Part 6A.1 requires bidders, who with their associates have at least 90% of the bid class securities after the bid, to offer, 'to buy out the holders of securities that are convertible into bid class securities'.[533] The buy out notice under s663B is required to, amongst other matters, 'set out the terms on which the holder may be bought out' and include an expert's report under s667A. Subsection 663C(2) provides that the notice gives rise to a contract between the holder and the bidder for the sale of the securities on either the terms agreed to by the bidder and the holder or as determined by the Court on application by the holder. Subsection 663C(3) provides that the first Court determination applies 'to all holders of securities in that class who have applications to the Court.'

Where a person, either alone or with a related body corporate, holds full beneficial interests in all of the securities in a class as a result of compulsory acquisition under Division 1 of Part 6A.2, the person is required under Division 3 of Part 6A.2 to offer to buy out securities that are convertible into securities in that class. The terms of this buy-out right are identical to Division 3 of Part 6A.1.

Bryson J in *Kingston v Keprose* described the buy out right in the *CASA* as 'quite similar to compulsory acquisition; the compulsion is economic and not legal'.[534] Jacobs J in *Mercantile Mutual v Actraint* described the policy of those provisions as ensuring that 'minority or non-accepting shareholders are no longer faced with the choice of either being "locked in" to a company under new control, or throwing themselves upon the mercy of the market place to dispose of their shares.'[535]

There is no explicit indication in Division 3 of Part 6A.1 or Division 2 of Part 6A.2 as to how the Court is to determine on what terms it is to value the securities concerned, other than the fact that the expert's report under 667A must state whether the terms offered 'give a fair value for the securities concerned', as defined in s667C. The pre-CLERP provisions in s703 of the *Corporations Law* and s43(5) of the *CASA* did not require the bidder to offer terms in the notice. However, if terms were offered, the notice was required to be accompanied by an expert's report, 'stating whether, in the expert's opinion, the terms proposed in the notice are fair and reasonable.'

Subsection 43(6) of the *CASA* provided that the terms on which the securities were to be bought out were either as 'agreed or as the Court, on the application of the offeror, on-market offeror or holder of the shares, option or note, thinks fit to order'. Bryson J took the view that s43(6) conferred 'on the Court a very wide discretionary power to fix the terms on which the options are to be acquired, extending so far as to allow the Court to have regard to any consideration which is not extraneous to the purposes of this provision of the Code'.[536] Jacobs J went further and arguably too far by saying that the Court's role in fixing a value calls for an exercise of intuitive judgment and judicial discretion which it is not possible to expound as a reasoned process'.[537] It is submitted that it is appropriate to undertake a process of reasoning when valuing securities.

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[533] Section 663A of the *Corporations Act*.
[534] (1988) 6 ACLC 111, 115.
[535] (1990) 1 ACSR 569, 577.
[536] (1988) 6 ACLC 111, 113.
[537] (1990) 1 ACSR 569, 571.

Both Bryson J and Jacobs J considered whether the concept of 'fair and reasonable' in what is now s640 of the *Corporations Act* was an appropriate consideration in determining a value of the securities. Bryson J said that while he was not saying that the term 'fair and reasonable' was not a relevant consideration, he did not regard it as correct to introduce a reference to 'fair and reasonable' into the valuation process.[538] Jacobs J on the other hand considered the debate as to whether the concept of 'fair and reasonable' should be imported into the determining of a value for the securities 'as largely sterile' because he considered it to be axiomatic that the Court is to determine a price which is fair to both the offeror and the holder of the securities.[539]

Both judges took into account factors which were extraneous to the fair value of those securities. As noted in section 4.2.3 above, Jacobs J came up with what he considered to be a more conservative valuation taking into account the fact that the holder was obtaining certainty as a result of the buy out right.[540] Bryson J applied a 25% discount on the grounds that:

- The buy-out right creates a barrier to bidders making takeovers where there are convertible securities.
- The defendant is acting as guarantor for the option holders and should get some 'recompense for that service.'[541]

While the present provisions do not specify directly that the Court must value the securities on the basis of s667C, all notices under Division 3 of Part 6A.1 and Division 2 of Part 6A.2 must include an expert's report which states whether the 'terms proposed in the notice give a fair value for the securities concerned'. It would seem a strange result for convertible security holders to receive an expert's report which states the terms in the notice does not provide a fair value for their securities as defined in s667C, but for the Court to ignore s667C in determining the value of the securities under s663C or s665C. It is submitted that for this reason Courts should be wary of taking into account for the purposes of determining the value of securities under s663C and s665C the advantage of

[538] (1988) 6 ACLC 111, 117.
[539] (1990) 1 ACSR 569, 578-579.
[540] Ibid 583-584.
[541] (1988) 6 ACLC 111, 120.

certainty to the holder and the disadvantages to the bidder of the provisions themselves. There have been enough changes in the buy-out provisions since *Kingston v Keprose* and *Mercantile Mutual v Actraint* for the Courts to depart from these judgments on this point.

Bryson J decided that the appropriate date to value the options was 11 March 1987, when the holder sent the notice requiring the bidder to purchase the options.[542] In *Mercantile Mutual v Actraint*, there were a number of holders who sent notices between 11 August 1989 and 26 September 1989. Jacobs J found that choosing the time for valuation was less important in this case, as there was no significant change in the asset backing or profitability of the company ‘throughout the whole of the period from 6 July 1989 to 30 September 1989’.[543] He identified 1 October 1989 as the date of the valuation.

Both Bryson J and Jacobs J awarded interest to the holders from a date that was one month from the date on which they valued the securities.[544] Unlike most other provisions in the *Corporations Act* relating to compulsory acquisition, subsections 663C(2) and 665C(2) provide sufficient scope for a Court to continue to award interest in future cases. This scope provides more evidence in favour of setting the date at which the majority of holders requested their securities to be bought back as the appropriate date to set for valuing those securities.

5.3 Selective capital reductions

Prior to the commencement of the *Company Law Review Act 1998* ("*CLRA*"), the *Corporations Law* made no distinction between equal and selective reductions of share capital. Capital reductions were subject to Court approval under s195 of the *Corporations Law*. Section 195 contained a number of protections for creditors.[545] The issue of fairness to minority shareholders was elaborated upon in case law.

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[542] (1988) 6 ACLC 111, 115.
[543] (1990) 1 ACSR 569, 581.
[544] (1988) 6 ACLC 111, 121 and (1990) 1 ACSR 569, 583 respectively.
[545] For example s195(3) and s195(5) required a detailed process for the protection of creditors.

The New South Wales Court of Appeal in *Catto v Ampol* followed a line of United Kingdom decisions in enunciating that the Court was required to consider whether the terms of the reduction were fair and equitable to minority shareholders.[546] As noted in section 3.3.3 and the commencement of Chapter 4, the Court of Appeal also considered that the equality of benefits principle, now enshrined in s602(c) of the Corporations Act, was a relevant factor to take into account in determining whether a Court should approve a capital reduction.[547]

Bryson J followed the principles in *Catto v Ampol* in *Nicron v Catto*.[548] Bryson J observed that the Courts 'have equated payment of the fair equivalent in money of the value of shares with fair and equitable treatment.'[549] He also considered that on the issue of protecting minorities, fair monetary compensation was the primary concern.[550]

The New South Wales Supreme Court on at least two occasions, in *Catto v Ampol* and *Melcann v Super John*, refused confirmation of capital reductions in relation to fairness of consideration. Other Australian jurisdictions have also followed the principles in *Catto v Ampol*. However prior to the commencement of the *CLRA*, subtle but important differences emerged between the New South Wales Supreme Court and other state Courts - in particular the Victorian Supreme Court.

While the Court of Appeal in *Catto v Ampol* did refer to the long established principle that the courts should not second-guess the commercial judgment of shareholders,[551] Victorian Courts have placed greater emphasis on this principle. In the Victorian Supreme Court decision of *Re Deniliquin Development Corporation Ltd*, the minority shareholders were offered the lowest point of the range assessed by the independent

[546] (1989) 15 ACLR 307, 313 (Priestly JA), 320 (Rogers AJA).
[547] Ibid 309-310 (Kirby P), 321 (Rogers AJA).
[548] (1992) 8 ACSR 219.
[549] Ibid 229.
[550] Ibid 231.
[551] (1989) 15 ACLR 307, 311 (Kirby P), 321 (Rogers AJA).

expert as fair. While Hayne J was initially concerned with this outcome, he noted that all of the shareholders had voted in favour of the proposal.[552] He concluded that:

> In the end the commercial judgment about whether the proposal is good or bad is a matter confined to shareholders whose property is being dealt with. Those shareholders who took the trouble to vote on the matter assented to the proposal.[553]

Hayne J took a similar approach in *Re Rancoo Ltd.*[554] In that case the capital of one shareholder was reduced for 35c per share. The expert has taken into account the effect of the sale of part of Rancoo's business to that shareholder and had determined the value of Rancoo's shares following the sale was between 17c and 24c per share. Therefore the expert concluded that the reduction was not fair to Rancoo's other shareholders.[555] While the expert had concluded that the shareholder was likely to receive up to $175,000 more for its Rancoo shares than they were worth, the shareholder was paying $1.9 million more for part of Rancoo's business than what that business was worth. On this basis the expert decided that the capital reduction was not fair but reasonable.[556] Hayne J approved the capital reduction on the following basis:

> The reduction has been approved by the members, by the requisite majority. No member appears to oppose confirmation of the reduction. Although, as I have earlier said, the terms in which the expert's report is put are such as to invite close attention to whether the reduction is one which the court should confirm, I am of the view that, when properly understood, the report of the independent expert is to the general effect that the transaction as a whole is one which is to the commercial advantage of shareholders.[557]

The judgments of Hansen J of the Victorian Supreme Court provide a further elaboration of the differences between the approaches of the New South Wales and Victorian Supreme Courts. For example in *Re Albert Street Properties Ltd*, an objector to the capital reduction relied on the decision in *Melcann* to argue, amongst other matters, that the consideration was not fair because it failed to take into account the 'special value' of

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[552] (1994) 12 ACLC 261, 263.
[553] Ibid.
[554] (1995) 17 ACSR 206.
[555] Ibid 209.
[556] Ibid.
[557] Ibid 209.

the company of $8.6 million in tax losses.[558] Hansen J agreed with the expert's valuation of the tax losses leading to the conclusion that a share in the company had a nil value.[559] Hansen J refused confirmation of the capital reduction however on the grounds that the expert had not taken into account the special value which may accrue to the majority shareholder in the company in its capacity as the predominant creditor to the company.[560]

Hansen J followed *Catto v Ampol* and *Nicron v Catto* in stating that the question was 'whether the reduction is fair and equitable to the shareholders in the full factual context in which it is proposed to be made'.[561] However he also noted Hayne J's comment in *Deniliquin*, which 'emphasised the importance of the commercial judgment of the shareholders in their vote on the issue in the light of all the relevant facts'.[562] He also concluded, at variance with the New South Wales Supreme Court, that the 'consideration to be paid on the expropriation of a share under a selective reduction does not have to equate to the value of the share' and 'the consideration need not equate to the value of any special benefit which one or more of the remaining shareholders might enjoy'.[563]

It is understandable for the Courts to be wary of second guessing the judgment of shareholders in determining whether the consideration offered under a selective capital reduction is fair. However this reticence ignores the fact that the shareholders' commercial judgement may be influenced by the fact that their choices are limited. They are given the choice either to accept the consideration offered or face the prospect of continuing to be locked into a minority position. It would appear that prior to the reforms in the *CLRA*, the New South Wales Supreme Court was more concerned about this situation than the Victorian Supreme Court.

[558] (1997) 23 ACSR 318, 326.
[559] Ibid 328.
[560] Ibid 329.
[561] Ibid 321.
[562] Ibid 329.
[563] Ibid. Hansen J expressed similar views in one of the last cases of court confirmation of a capital reduction under s195 of the *Corporations Law*; *Quatro Ltd v Argo Investments Ltd* (1999) 32 ACSR 239, 257- 259.

Capital reductions under Division 1 of Part 2J.2 of the *Corporations Act* no longer require Court approval. Subsection 256B(1) provides that a ‘company may reduce its share capital in a way that is no otherwise authorised by law if the reduction:

(a) is fair and reasonable to the company’s shareholders as a whole;
(b) does not materially prejudice the company’s ability to pay its creditors; and
(c) is approved by shareholders under section 256C.

Paragraph 12.24 of the *Explanatory Memorandum to the Company Law Review Bill 1997* states in relation to the expression ‘fair and reasonable to the company’s shareholders as a whole’:

> ‘Fair and reasonable’ is intended to be a composite requirement. Factors that might be relevant to determining whether a capital reduction is fair and reasonable to shareholders as a whole include the following:
>
> (a) the adequacy of any consideration paid to shareholders[;]
> (b) whether the reduction would have the practical effect of depriving some shareholders of their rights (for example, by stripping the company of funds that would otherwise be available for distribution to preference shareholders)[;]
> (c) whether the reduction is being used to effect a takeover and avoid the takeover provisions[; and]
> (d) whether the reduction involves an arrangement that should more properly proceed as a scheme of arrangement.

As Santow J observed in *Goldfields Kalgoorlie1*, the capital reduction provisions introduced by the *CLRA* ‘finally caught up with the commercial world’[564], by making a distinction between equal and selective reductions of capital. Subsection 256B(2) provides that an capital reduction is an equal reduction if the reduction relates to ordinary shares, applies to each holder of ordinary shares in proportion to the number of ordinary shares they hold and the terms of the reduction are the same for each holder of ordinary shares. Any reduction that does not satisfy these criteria is a selective reduction. Therefore compulsory acquisition of a minority by means of a capital reduction would be a selective reduction.

Subsection 256C(2) requires that a selective reduction must be approved by either:

[564] (2000) 34 ACSR 737, 739.

(a) a special resolution passed at a general meeting of the company, with no votes being cast in favour of the resolution by any person who is to receive consideration as part of the reduction or whose liability to pay amounts unpaid on shares is to be reduced, or by their associates; or
(b) a resolution agreed to, at a general meeting, by all ordinary shareholders.

While paragraph (a) of s256C(2) prohibits any vote 'being cast in favour of the resolution by any person who is to receive consideration as part of the reduction or whose liability to pay amounts unpaid on shares is to be reduced, or by their associates' it does not prohibit votes by such persons being cast against the resolution. This will not normally affect compulsory acquisition of a minority by way of selective reduction, as the majority will usually be able to carry the resolution even if some of the minority vote against it.[565] It is likely that the Courts will read down the words 'no votes being cast in favour' so that a reduction is not invalidated because a shareholder attempted to cast a vote in favour so long as the company concerned did not count that vote.[566]

Where a selective reduction involves the cancellation of shares, as will be the case when it is used to compulsorily acquire the shares of a minority, the 'reduction must also be approved by a special resolution passed at a meeting of the shareholders whose shares are to be cancelled'. The New South Wales Court of Appeal in *Goldfields Kalgoorlie2* has held that this resolution must be put to a separate 'class' meeting of these shareholders.[567]

As discussed in section 4.3.1, Santow J in *Goldfields Kalgoorlie1* was of the view that s667C(1) was relevant in determining the meaning of 'fair and reasonable to the company's shareholders as a whole' in s256B(1)(a) but that it was not conclusive. Earlier in his judgment he states that he does not consider that 's667C has an invariable effect upon the construction of s256B'. He notes that s667C was added to the then *Corporations Law* one year later than s256B and therefore concludes that 'it would be

[565] More problems may arise in the case of merger schemes of arrangement where there are only a few continuing shares held by the friendly bidder. Santow J in *Re Tiger Investment Company Ltd*, (1999) 33 ACSR 438, 444 showed sympathy for the proposition that as the consideration for the capital reduction in that merger scheme came from a third party, all the shareholders were able to cast votes either for or against the resolution.
[566] Ibid 445.

surprising if the effect of s667C was so far-reaching as to entirely preempt what was a fair and reasonable value'.[568] After discussing the meaning of s667C, Santow J noted Kirby P's view in *Catto v Ampol* that the provisions of corporate law should be read together and the Court should endeavour to 'provide an interpretation of them which affords a harmonious, practical and mutually supportive operation of each.'[569] He concluded that the 'harmonious and mutually supportive operation for Chs 6A and 2J is ordinarily achieved in transactions within Ch 2J by the allocation of special benefits as reflected in any premium pro rata between the shareholders as a whole.'[570] He also stated in passing that s667C had 'a strong gravitational pull upon the parallel provisions for selective reductions of capital in Pt 2J.1.'[571] He also points out that the words "as a whole" in s256B(1)(a), 'require fairness and reasonableness as between majority and minority, not some one sided allocation.'[572]

In relation to the allocation of special benefits, as he was of the view that s667C(1) was not completely determinative in the interpretation of s256B(1), Santow J suggested some possible examples of where special benefits should not be distributed pro rata. He intimated that the allocation might be different if it is the majority interest to be acquired.[573] He also suggested the following examples:

> An example would be where the special value derives not only from 100% ownership, but also extraordinary efforts on the part of the 100% parent, such as to exploit a particular resource. There is also the converse case where 100% ownership is of such unique value to the 100% parent, that it may be arguable that more should be attributed to the minority than the pro rata amount.[574]

The Explanatory Memorandum to the *Corporate Law Review Bill 1997* and Santow J's comments in *Goldfields Kalgoorlie1* provide support for the proposition that the expression 'fair and reasonable to the company's shareholders as a whole' encompasses

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567 (2001) 40 ACSR 222, 235 (Giles JA).
568 (2000) 34 ACSR 737, 750.
569 Ibid 751, quoting from (1989) 15 ACLC 717 at 720.
570 Ibid.
571 Ibid 753.
572 Ibid 752.
573 Ibid.
574 Ibid.

consideration of a number of factors. The operation of s667C is one factor to be taken into account. A selective reduction, which proposes consideration to the minority shareholders less than the fair value for the shares under s667C, risks a Court injunction under s1324(1) and s1324(1)(c) on the grounds that the selective reduction is not 'fair and reasonable to the company's shareholders as a whole'.

In relation to disclosure, s256C(4) requires the notice of meeting to include 'all information known to the company that is material to the decision on how to vote' on the resolution to approve a capital reduction. As a selective reduction is dependent on the vote of those minority shareholders whose shares are to be cancelled, Hansen J's decision in *Re Albert Street* applies, requiring disclosure of special benefits, which are known to the company.

There was no requirement in s195 of the *Corporations Law* for an independent expert's report to be provided to shareholders in the case of a reduction of capital. ASIC Practice Note 29 at [PN29.27] however states 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'. Division 1 of Part 2J.1 similarly contains no requirement for an independent expert's report, but most companies would consider obtaining such a report in the cases of selective capital reductions to provide proof that the reduction is 'fair and reasonable to the company's shareholders as a whole'.

5.4 Schemes of arrangement

Section 411 of the *Corporations Act* allows for a compromise or arrangement with any company and its members or creditors. If the requirements of s411 are met, a scheme binds members or creditors into 'compulsory contractual obligation'.[575] The Courts have held that option holders and convertible noteholders are creditors for the purpose of

[575] *Isles v Daily Newspapers Ltd* (1912) 14 CLR 193, 205 (Isaacs J).

s411.[576] Therefore schemes of arrangement cover a greater number of types of securities than capital reductions, which are limited to shares.

For a scheme of arrangement to bind members or creditors:

- The Court must approve the holding of the scheme meetings and the explanatory statement to be sent to member and/or creditors.[577]
- The scheme or schemes must be approved by 50% of the class of members or creditors and 75% of the value of the class of shares or debts.[578]
- After the members and/or creditors have given approval, the Court must approve the scheme.[579]

The voting hurdles for a scheme of arrangement are therefore greater than in the case of a capital reduction as there is a requirement for 50% approval of holders of shares or debt. A class for the purposes of schemes of arrangement is confined to those persons whose rights 'are not so dissimilar as to make it impossible for them to consult together with a view to their common interests'.[580] In the case where a majority security holder wanted to compulsorily acquire the minority shareholders by way of a scheme, that majority security holder would usually constitute a separate class from the minority shareholders.

An expert's report is required when:

- the 'other party' to the scheme, in other words the bidder, has 30% of the voting shares of the company; or
- if the voting shares of the company are divided into two or more classes, the bidder has 30% of the voting shares in at least one of those classes; or
- the bidder and the company share one or more directors.[581]

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[576] *Re US Masters Ltd* (1991) 4 ACSR 462, 464.
[577] Subsection 411(1) of the *Corporations Act*. ASIC must be given 14 days notice of the date of the hearing and the Court must be satisfied that it has had enough opportunity to examine the contents of the draft explanatory statement and make submissions to the Court – s411(2) & (3). If the scheme of arrangement only relates to members, it must be registered by ASIC – s412(6). ASIC must not register the explanatory statement if it is false or misleading in a material way – s412(8).
[578] Subsection 411(4) of the *Corporations Act*.
[579] Subsection 411(6) of the *Corporations Act*.
[580] *Sovereign Life Assurance Co. v Dodd* [1882] 2 QB 573, 583, quoted in *Re Jax Marine Ltd & Companies Act* (1966) 85 WN (Pt. 1) (NSW) 130, 133.
[581] Clauses 8303 and 8306 of Part 3 of Schedule 8 of the *Corporations Regulations*.

Where an expert's report is required, it must disclose whether 'the proposed Scheme is in the best interests of the members of the company the subject of the Scheme' and setting out reasons for that opinion.[582] ASIC Policy Statement 75 suggests that the expressions 'fair and reasonable' and 'in the best interests of the members' are interchangeable.[583] A number of independent experts have commented that schemes can cover a wider range of activity than takeovers and that therefore the expression 'in the best interests of members' is a broader concept than 'fair and reasonable'.[584] In the case of compulsory acquisition however, the two phrases are likely to be considered interchangeable. ASIC consent is required where:

- an expert's report is required; and
- there is a forecast of the profits or profitability of the company or a valuation of an asset of the company that differs from that in the books of the company.[585]

Court decisions on schemes have not imported a requirement that the scheme consideration be fair or equitable in the same way as they did in the case of capital reductions under s195 of the *Corporations Law*. The Courts have stated that they are required at the approval stage under s411(6) to be satisfied that:

- 'a resolution approving the scheme was passed by the statutory majority at a duly convened meeting';[586] and
- 'the scheme is on its face sufficiently fair and reasonable as to be capable of being put to shareholders for their approval or rejection'[587] or putting it another way is 'at least so fair and reasonable, as that an intelligent and honest man, who is a member of that class, and acting alone in respect of his interest as such member, might approve it.'[588]

ASIC Policy Statement 142 states that:

> ASIC will consider whether minority shareholders are adequately informed and fairly treated (although it was concerned with a different process, the High Court decision in *Gambotto & Anor v WCP Limited & Anor* (1995) 16 ACSR 1 may be a handy guide for

[582] Clause 8303 of Part 3 of Schedule 8 of the *Corporations Regulations*.
[583] ASIC Policy Statement 75, [PS 75.6].
[584] See for example SG Hambros Australia Limited, above n 160, 3-4.
[585] Clause 8305 of Part 3 of Schedule 8 of the *Corporations Regulations*.
[586] *Re Huon Valley Springs* (1986) 10 ACLR 883, 886.
[587] *Re GIO Australia Holdings Ltd* (1999) 33 ACSR 283, 286.
[588] Ibid.

> review of fairness and disclosure in cases where minorities are to be expropriated). This consideration will involve examining whether…the consideration to be received by minority shareholders is fair, insofar as fairness is determined by minority shareholders receiving reasonable and equal opportunity to share in the benefits which will flow to the majority shareholder by virtue of the scheme proceeding.
>
> Whether the consideration is fair will depend on factors such as the company's assets and liabilities, the market value of the company's securities, past and likely future dividends and the nature of the corporation and its likely future. In addition, following the decision of the Supreme Court of New South Wales in *Melcann Limited v Super John Pty Limited & Anor* (1995) 13 ACLC 92, any special benefit that will be obtained by the majority shareholder following the acquisition of the minority shareholders' shares will also be relevant in determining whether the consideration is fair.

Re Hudson Conway Ltd[589] provides a practical example of ASIC and the Courts' attitude to schemes that compulsorily acquire securities for arguably less than fair value. In that case, ASIC originally held some concerns about the adequacy of information proposed to be sent to shareholders under the scheme. ASIC obtained its own expert's report from PricewaterhouseCoopers, which valued the benefit that the remaining shareholder (Mr Lloyd Williams) would obtain from the scheme at between $42.5 million and $65.8 million. Hudson Conway's expert valued the potential benefit to Lloyd Williams at between $800,000 and $3.3 million.[590] Hudson Conway offered to send the PricewaterhouseCoopers report to shareholders and on that basis ASIC did not oppose the scheme at either Court hearing.

Some of the minority shareholders opposed the Court confirmation under s411(6) primarily on the grounds that insufficient prominence had been given to the PricewaterhouseCoopers report and there were deficiencies in disclosure generally. Beach J in approving the scheme under s411(6) stated that the shareholders of Hudson Conway 'were required to make a commercial decision on the matter. They were better judges of what was in their commercial advantage than this court'.[591] In support of this proposition, Beach J noted Hudson Conway's evidence that a number of large institutions had voted in favour of the scheme.[592]

[589] (2000) 33 ACSR 657.
[590] Ibid 666.
[591] Ibid 662.
[592] Ibid.

It would seem reasonable to apply the principle in capital reduction cases enunciated in *Re Albert Street* to schemes of arrangement; to argue that a scheme should disclose the extent to which the majority security holder may reap special benefits from the scheme. The issue of disclosure of special benefits in a scheme arose in *Re GIO Building Society*.[593] GIO Building Society Limited was a company limited by shares and guarantee. GIO Personal Investment, a wholly owned subsidiary of AMP Limited, held the shares. The members were customers of GIO Building Society. Members who met defined eligibility criteria were entitled to one vote per member. The members as a whole only had approximately 0.04% of the votes, which could be cast at a general meeting. GIO Personal Investment held the remaining votes. Only the shares carried a right to dividends but the members had a right to distribution on a winding up.[594] GIO Building Society proposed by way of scheme to cancel the non-shareholder memberships 'in consideration of a payment, in most cases, of $100 per membership'.[595]

Austin J was concerned about the level of disclosure in the proposed explanatory memorandum. He discussed the issues with GIO Building Society and ASIC over the course of seven hearings and at one stage gave a written preliminary opinion to the parties.[596] At first Austin J was concerned that if GIO Building Society were wound up, members would be entitled to a distribution of around $2,100 each.[597] He expressed the view on reading one draft of the explanatory memorandum that it had not adequately explained why winding up of the GIO Building Society was unlikely.[598] The final version of the explanatory statement made it clear that a voluntary winding up would not occur as it required the consent of GIO Personal Investments[599] and it was unlikely that a member could obtain an order that GIO Building Society be wound up on just and

[593] (2001) 39 ACSR 77.
[594] Ibid 82.
[595] Ibid 78.
[596] Ibid 77, 79.
[597] Ibid 79.
[598] Ibid.
[599] Ibid 89.

equitable grounds as neither the directors of GIO Building Society nor GIO Personal Investment had an intention to manage GIO Building Society in an oppressive manner.[600]

Austin J was also concerned that the draft explanatory memorandum and expert's report did not adequately deal with the issue of special value:

> It seems to me that in addition to the other evidence to which I have referred, there will need to be evidence either on affidavit or by the valuer giving an estimate of the value to the majority shareholder and the AMP group of implementation of the scheme – including the benefits which will arise upon rationalisation of the corporate structure in the manner proposed by the scheme. When that evidence is to hand, it will be significant information for members to consider in assessing the proposed scheme.[601]

In considering *Melcann*, *Goldfields Kalgoorlie1* and *Pauls2*, Austin J considered that in the case before him non-shareholder members might be entitled to more than a pro rata share of special value, as this is a situation that is different from a case of compulsory acquisition by one majority holder. Rather it involves compulsory acquisition of an entire class of members.[602] In his final judgment he withdrew this view. He noted that the final form of the explanatory memorandum did not agree with his initial view that the members may be entitled to more than a pro rata share of special value. The final form of explanatory memorandum stated that the non-shareholder members would receive approximately 16% of the value of the GIO Building Society. The directors argued that this was reasonable as the shareholder had 99.96% of the voting rights, contributed all of the share capital and was entitled to all of the dividend rights.[603] Austin J concluded that:

> By making my orders for the convening of meetings, I have effectively withdrawn from any expression of opinion on the point, the resolution of which should not be undertaken unless the point is the subject of argument at a contested hearing.[604]

As noted in section 4.4 above, s51(xxxi) of the *Australian Constitution* is unlikely to apply to compulsory acquisition under the *Corporations Act*. However it should be noted

[600] Ibid 90.
[601] Ibid 80.
[602] Ibid 80-81.
[603] Ibid 91-92.
[604] Ibid 81.

that if it did apply, a majority security holder attempting to compulsorily acquire securities of minority holders by way of scheme for less than fair value as defined under s667C may face the prospect of an action by a security holder under s1350 for further compensation on the grounds that just terms were not offered. It is arguable in the case of merger schemes however, that where the target and bidder are not related, the price obtained by the target directors under the scheme should prima facie be seen as fair value under s667C and just terms under s1350. Whether a Court takes such a view (or in fact is required to decide whether to take such a view) remains to be seen.

5.5 Other forms of compulsory acquisition

There may continue to be limited scope for companies to compulsorily acquire a minority shareholder's shares by way of an amendment to the constitution under s136(2) of the *Corporations Act*. The majority of the High Court in *Gambotto* stated that two situations where compulsory acquisition by way of an amendment to the constitution may be valid are where the minority shareholder is competing with the company or where the compulsory acquisition is necessary because of a regulatory requirement.[605] As the High Court did not rule out the possibility of the majority shareholder voting in favour of such an amendment, it is possible that compulsory acquisition under these circumstances is best achieved by way of an amendment to the constitution, as opposed to a capital reduction or scheme. The majority of the High Court also specified that compensation offered under compulsory acquisition be at a fair price. Given the principle in *Catto v Ampol*, it is likely that Courts in the future will consider the operation of s667C in the determination of fair price for compulsory acquisition by means of an amendment to a company's constitution.

Section 507 of the *Corporations Act* gives a liquidator the power, with the sanction of a special resolution of the company, either a general or specific authority to sell assets in exchange for 'shares, debentures, policies or other like interests'. Subsection 507(4) provides that:

> If a member of the company who did not vote in favour of a special resolution expresses dissent from the resolution in writing addressed to the liquidator and left at the office of the liquidator within 7 days after the passing of the resolution, the member may require the liquidator either to abstain from carrying the resolution into effect or to purchase the member's interest at a price to be determined by agreement or by arbitration under this section.

Subsection 507(9) gives the Court the power to 'give any directions necessary for the initiation and conduct of the arbitration and any such direction is binding on the parties'. It has been observed that s507 could be used for mergers or compulsory acquisitions.[606] There appears little reason why the Courts, in giving directions under s507(9), would not apply the *Catto v Ampol* principle and seek guidance from s667C.

5.6 Common themes in the application of s667C

One conclusion that arose from the discussion in Chapter 4 is that fair value under s667C, in the case of voting shares, does not include a minority discount and includes universal synergies. Santow J would also argue, at least in the case of voting shares, that s667C would include special benefits or alternatively reflexive value. Section 667C also provides a methodology to value securities other than voting shares. As discussed in Chapters 3 and 4, there will be instances where some control premium and universal synergies should be included in the determination of fair value of securities other than voting shares, depending on the residual voting and other rights which attach to those securities.

This Chapter, in turn, has shown that s667C may provide additional protection to minority security holders who are faced with compulsory acquisition. Prior to the commencement of the *CLERP Act*, there was one common principle, which influenced what Boros referred to as the conflicting policies reflected in the various methods of compulsory acquisition.[607] In relation to compulsory acquisition following a takeover

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[605] (1995) 182 CLR 432, 445.
[606] Quentin Digby, above n 106, 116.
[607] Elizabeth Boros, above n 3, 292.

and schemes of arrangement, the Courts usually left the judgment of fairness of consideration to the security holders themselves. This principle also affected capital reduction cases, at least in the Supreme Court of Victoria. It may also provide part of the explanation as to why the cases relating to buy-out rights following a takeover took into account in determining price the benefit to minority security holders in obtaining certainty in being bought out. This principle in the context of compulsory acquisition following a takeover is likely to have been the major influence on ASIC's pragmatic policy of allowing experts to conclude that consideration offered under a takeover, capital reduction or scheme is not fair but reasonable.

Leaving the issue of fairness to the security holders themselves has one major drawback. A majority security holder can offer the minority substantially less than fair value and the majority of the minority security holders may feel there is little alternative but to accept this proposal. There is therefore scope for the majority security holder to oppress the minority and eliminate the holdings of the minority for less than fair value. However minority security holders may prefer to be paid out at less than fair value rather than be locked into a minority position.

Section 667C has affected materially the application of this principle. Successful challenges to compulsory acquisition following a bid are now dependent on the Court being satisfied that the consideration offered under the bid is not fair value as defined under s667C. A selective capital reduction under Division 1 of Part 2J.1, which offers consideration which is not fair as defined under s667C, runs the risk of being challenged on the basis that the reduction is not ‘fair and reasonable to the company's shareholders as a whole’.

It is submitted that s667C’s greatest work in relation to compulsory acquisition outside Part 6A.2 is to provide protection for minority security holders from compulsory acquisition by the majority security holder at less than fair value. This particularly holds true in the case of compulsory acquisition following a takeover by a majority security holder and capital reductions. In the case of takeovers by a bidder who prior to the takeover is not in control of the target, the bid price appears to the best estimation of fair value. This conclusion is supported by the discussion of commentators in the United States referred to in section 3.3.4 that concludes that the best indicator of value in the takeovers context is the price paid by a successful non-associated bidder.

The only example of where s667C may not be directly applicable is in the case of schemes of arrangement. Schemes have the added protection of requiring under s411(4) a resolution of a majority of members or creditors. However there remains the possibility that members and creditors may see little choice but to vote in favour of a scheme as opposed to being locked into a minority position. One possible suggestion for reform is to give dissenting shareholders (and perhaps other security holders who are deemed to be creditors) the right to seek appraisal for their shares in the same way as shareholders have a right under s507(4). Arguably this right should be limited to schemes that seek to compulsorily acquire the minority rather than merger schemes. Again drawing from the learning from the United States, a merger scheme between unrelated parties would come to a fair price by way of negotiation assuming that the directors of the target company were acting in accordance with their fiduciary and statutory duties.

The other issue is the extent to which s667C should affect valuation exercises by experts where they are required under the *Corporations Act*. It is likely that Courts in the future will:

- Interpret ‘fair and reasonable’, ‘fair and reasonable to the company’s shareholders as a whole’ and ‘in best interests of the members of the company’ as composite phrases.
- Consider that, in conjunction with other factors, fair value under s667C is a relevant consideration in determining whether consideration or a proposal is ‘fair and reasonable’, ‘fair and reasonable to the company’s shareholders as a whole’ or ‘in best interests of the members of the company’.

Therefore it is likely that over time, experts will begin to refer to s667C in expert reports for matters other than compulsory acquisition under Part 6A.2. Section 667C is also likely to be relied upon in any policy review of ASIC Policy Statement 75.

6. Conclusion

This paper has explained and clarifies the elements of confusion that arise in the interpretation and application of s667C of the *Corporations Act*. Section 3.1 provided an explanation of terminology involved in the valuation of securities for the purposes of compulsory acquisition by providing definitions of expressions such as 'minority discount', 'control premium' and 'special benefits'.

Section 3.2 described the major valuation methodologies to provide guidance as to what elements of value such methodologies may include or exclude. Section 3.3 examined the confusion surrounding the policy debate regarding the valuation of securities for the purpose of compulsory acquisition and enunciated some clear policy conclusions. These conclusions in summary were that:

- In the case of voting shares, a minority discount should not be included and universal synergies should be included.
- Special benefits should not be taken into account in relation to any securities.
- Whether a minority discount or universal synergies are taken into account in relation to securities other than voting shares will depend on the voting rights, distribution rights and rights to assets that attach to those securities.

Section 3.4 of this paper tested these propositions in relation to the application of valuation methodologies and the policy behind valuing securities for the purposes of compulsory acquisition by considering cases from the Supreme Court of Delaware. Many of these Delaware cases had to wrestle with confusion relating to similar concepts and provide useful lessons for Australian Courts in the future.

Chapter 4 considered s667C and the cases that have examined s667C. This Chapter concluded by supporting the conclusions reached in Chapter 3 – for example in the case of voting shares neither a minority discount nor special benefits should be taken into account.

Chapter 5 considered the confusion relating to the 'gravitational pull' of s667C on the various forms of compulsory acquisition other than Part 6A.2. This Chapter concluded by suggesting that s667C's most important application to these other forms of compulsory acquisition is in the case where minority security holders may be in danger of receiving less than fair value for their securities because of the power of the majority security holder. In the case where a merger has been agreed between non-associated parties at arms length or where a bidder who does not initially have control of the target makes a takeover bid, s667C has less obvious application.

A further possible source of confusion is in relation to the possible continued application of *Gambotto* to various forms of compulsory acquisition under the *Corporations Act*. Recent case law would suggest that the application of *Gambotto* to the various forms of compulsory acquisition, other than through an amendment to a company's constitution, is extremely limited. Both Santow J in *Goldfields Kalgoorlie1*[608] and Giles JA in *Goldfields Kalgoorlie2*[609] held that the express provisions relating to fairness under the capital reduction provisions meant that the principles in *Gambotto* had no direct application to capital reductions. Warren J in *Capricorn Diamonds* concluded that the principles in *Gambotto* 'are of no or limited application' to cases under Part 6A.2.[610] As discussed in section 2.1, s661E(2) of the *Corporations Act* was designed to ensure that the Courts' consideration of whether it should order that securities not be compulsorily acquired after a bid is limited to fairness under s667C. The aim therefore of drafting s661E(2) was to eliminate any possibility that the *Gambotto* principles may apply to compulsory acquisition following a bid.

Santow J in *Kelly-Springfield* referred to the principles relating to fairness in price in *Gambotto* to justify the inclusion of reflexive value in the 'value of the company as a whole' in s667C(1)(a).[611] However as discussed in section 4.3.3, this application of the *Gambotto* principles is not without problems. The passage Santow J uses from *Gambotto*

[608] (2000) 34 ACSR 737, 746-748.
[609] (2001) 40 ACSR 221, 246.
[610] [2002] VSC 105, [83].
[611] [2002] NSWSC 53, [74].

is a reference to the Delaware decision of *Weinberger*,[612] which does not stand for the proposition that special benefits or reflexive value should be included.

Therefore it is likely that the *CLERP Act* reforms have greatly curtailed the application of the *Gambotto* principles to compulsory acquisition under the *Corporations Act*. Future compulsory acquisition cases are more likely to consider the impact of s667C than of *Gambotto*. To that extent the goals of the Legal Committee of CASAC, as described in section 2.1, appear to have been achieved. However it is unlikely that the Legal Committee of CASAC was aware that s667C had the capacity to take over from *Gambotto* as a major protection for minority security holders. Whether s667C lives up to this potential will be seen in future cases.

[612] 457 A. 2d 701, 711 (1983).

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