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Escalation Agreements – An Escalator to Nowhere?

The prohibition of escalator clauses under section 622 of the Corporations Act is intended to ensure the fair and equal treatment of all shareholders. However, in many cases the prohibition may be unwarranted where no real benefit is received. This FocusPaper provides an examination of the issue, particularly in light of the decisions of *Savage Resources*, *Cultus Petroleum* and *GoldLink IncomePlus*.

In the world of takeovers prospective bidders often enter into pre-bid agreements with substantial shareholders of target companies in order to build up a strategic stake before launching a takeover bid. These agreements will often be structured so that the selling shareholder is guaranteed to receive at least the same consideration for its shares that will be offered by the prospective bidder if, and when, a bid is made.

However, such structures run the risk of breaching section 622 of the Corporations Act 2001 (Cth) (**Act**) which prohibits escalation agreements, even where a selling shareholder is entitled to receive the same consideration as other target shareholders. A recent Takeovers Panel decision places the spotlight on whether the prohibition of escalation agreements is still an effective safeguard for protecting shareholders' rights or is simply an "escalator to nowhere", impeding corporate acquisitions and creating an artificial hurdle to the free-flow of capital.

Section 622 Prohibition

Section 622(1) of the Act prohibits escalation agreements under which a person gives or receives a benefit and/or the value of which is linked to a bid or proposed bid. Specifically, a person who makes or proposes to make a takeover bid¹ for securities will contravene the section if:²

- (a) the person acquires a relevant interest in securities within the 6 months before the bid is made or proposed (**Acquisition**);

¹ A "takeover bid" means an off-market or market bid made under Chapter 6. It does not include any other method of acquisition, such as a scheme of arrangement.

² This is only a summary of section 622.

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- (b) at any time, the bidder or proposed bidder gives or agrees to give a benefit³ to, or receives or agrees to receive a benefit from, a person who had a relevant interest in the securities referred to above immediately before the Acquisition;
- (c) the benefit is attributable to the Acquisition or matters that include the Acquisition; and
- (d) the amount or value of the benefit is, or is to be, determined by reference to or to matters that include the amount or value of the consideration for the securities under the bid or proposed bid.

By way of example, the following hypothetical scenario may fall within section 622:

- A enters into an agreement to buy 1,999 shares (equal to 19.99% of all voting shares) in C (*sale shares*) that are held by B for \$1.00 per sale share (*agreement*).
- The agreement contains a clause that if A makes a takeover bid for all or a prescribed percentage of the shares in C, A will be required to pay B the amount, if any, that the takeover bid consideration exceeds the purchase price of \$1.00 per sale share (*escalation clause*).
- Three months after completion of the agreement, A makes a takeover bid for all of the outstanding shares in C for bid consideration of \$1.50 per share.
- Under the escalation clause, A would be required to pay B an extra \$0.50 for each of the sale shares.

In the scenario above, the escalation clause would be *prima facie* void pursuant to section 622(2). An offence under section 622(1) is a strict liability offence and attracts a maximum penalty of \$2,750 (\$13,750 for a body corporate) or 6 months imprisonment or both.

Savage Resources Ltd v Pasminco Investments Pty Ltd⁴

One of the leading cases in this area is *Savage Resources Ltd v Pasminco Investments Pty Ltd*. The facts of *Savage Resources* were:

- Pasminco Investments Pty Ltd (**Pasminco**) entered into sale agreements to purchase the shares in Savage Resources Limited (**Savage**) held by certain shareholders of Savage (**Selling Shareholders**).
- The Selling Shareholders had a right to terminate the sale agreement if another bid was made for Savage shares which was not matched by Pasminco or if Pasminco made a bid.
- Pasminco subsequently made a takeover bid for Savage shares.

The court held that the right of the Selling Shareholders to sell into the Pasminco bid (and therefore receive a higher price for their shares under the bid and avoid their obligation to complete the share sale agreement with Pasminco) did not contravene the predecessor to section 622. This was because the right to sell into any takeover bid whether by Pasminco or

³ A “benefit” means any benefit, whether by way of payment of cash or otherwise.

⁴ (1998) 159 ALR 304

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any other bidder was a pre-existing right of the sellers as shareholders of Savage, and simply not a “benefit” for the purposes of section 622(1).

The court also found that the termination rights of the Selling Shareholders were not “benefits” for the purpose of section 698 of the Corporations Law (now the “collateral benefit” section 623 of the Act). This was because the purpose and effect of those termination rights was to ensure that the selling shareholders were not disadvantaged compared to the general body of Savage shareholders.⁵

In making his decision, Hely J referred to *Primac Holdings v Iama Ltd & Ors*⁶ which involved a pre bid option that contained a stipulation that the granting of it would not preclude the grantee from selling into the bid. In that case Dowsett J held that the right to sell into the bid was simply a right retained by the grantor, notwithstanding the grant of the option, to accept any subsequent offer made by the grantee for the shares the subject of the option.

The court in *Savage Resources* also relied on the decision in *Boral Energy Resources Ltd v TU Australia (Queensland) Pty Ltd*⁷. In that case Santow J considered that an opportunity to revoke a pre-existing contract for the sale of shares that subsequently became the subject of a takeover offer and to sell those shares into such takeover offer, was not a “benefit” of the kind contemplated by section 698 and was “inherently speculative” in nature.

Cultus Petroleum NL v OMV Australia Pty Ltd⁸

The reasoning by the court in *Savage Resources* was subsequently applied by the New South Wales Supreme Court in *Cultus Petroleum NL v OMV Australia Pty Ltd*. The facts of this case were:

- OMV Australia Pty Ltd (**OMV**) entered into an agreement with Portfolio Partners Limited (**Portfolio**) to acquire Portfolio’s shares in Cultus Petroleum NL (**Cultus**).
- OMV subsequently made a takeover bid for shares in Cultus.
- The share sale agreement between OMV and Portfolio included a clause that the agreement would terminate if another takeover bid for all the shares in Cultus was open for acceptance at a higher price or value than as provided for in the agreement and OMV did not increase its bid price to at least match that higher price or value.

The court held that the share sale agreement amounted to a conditional agreement to accept the takeover when made and did not contravene section 697 of the Corporations Law, being the predecessor to section 622 of the Act. The court stated:⁹

“For the reasons earlier stated, I am satisfied that no contravention of s697 occurred...under the terms of the relevant agreement. That agreement amounts to a conditional agreement to accept the takeover offer when made. The benefits Portfolio Partners derive from that agreement are essentially those derived from accepting the takeover offer and are conferred by that offer; they are not calculated by reference to it.

⁵ (1998) 159 ALR 304 at 319

⁶ (1996) 22 ACSR 454

⁷ (1998) 28 ACSR 1

⁸ (1999) 32 ACSR 1

⁹ (1999) 32 ACSR 1 at 7 to 8 (paragraphs 13 and 14)

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The ability of Portfolio Partners to terminate its pre-acceptance upon the making of a higher bid does not constitute a benefit of the kind prohibited by s697...

Put another way, such a "benefit" is not conferred upon Portfolio Partners but is simply retained, and its nature is inherently speculative depending as it does upon whether or not a competing higher bid does emerge."

Meaning of "benefit"

Other than the cases referred to above, there has been little judicial analysis about what exactly constitutes a "benefit" for the purposes of section 622. However, there are a number of cases discussing what constitutes a "benefit" for the purposes of section 623 - being the section that regulates collateral benefits in the context of a takeover. In those cases, there is support for a "net benefit" approach which involves considering the transaction and its effect as a whole. Under the "net benefit" approach, a bidder will not necessarily breach section 623 (even though it may have given a particular "benefit" to a target shareholder) if, after taking into account all of the relevant circumstances, that target shareholder will be in the same, or worse, position as other target shareholders. The "net benefit" approach involves looking at the commercial balance of advantages flowing to or from the non-bidder from a transaction which is sought to be impugned.¹⁰

Having regard to the case authorities, it might be argued that an escalation agreement, which only seeks to ensure the selling shareholder receives the same consideration as other target shareholders in the event of a bid, is also not a "benefit" and hence its giving or receipt should not be prohibited by section 622. However, it remains unclear whether the courts will apply the "net benefit" approach for the purposes of section 622.

GoldLink IncomePlus Limited 02¹¹

In a recent case, the Takeovers Panel declined to conduct proceedings in respect of an escalation agreement alleged by the applicant to be in breach of section 622. In the matter of *GoldLink IncomePlus Limited 02*, GoldLink IncomePlus Limited (**GoldLink**) sought a declaration of unacceptable circumstances¹² relating to an escalator provision in an agreement entered into between Emerald Capital Limited (**Emerald**) and Challenger Managed Investments Limited (**Challenger**). The escalator provision had the effect of increasing the purchase price for GoldLink shares purchased by Emerald from Challenger as a result of a takeover bid being made by Emerald for shares in GoldLink. The increase in the purchase price payable to Challenger was capped so that it did not exceed the consideration under Emerald's takeover bid.

The Panel concluded that there was no reasonable prospect that it would make a declaration of unacceptable circumstances if it conducted proceedings. In deciding not to conduct proceedings, the Panel stated that the escalator provision:¹³

"...had the effect that Challenger would not receive consideration additional to that offered to GoldLink shareholders under the takeover bid. In the circumstances, it was difficult to see how the "equality principle" in s602 was offended, as no GoldLink shareholder that accepted the bid would receive less consideration than Challenger."

¹⁰ *Re Powertel Ltd (No 3)* [2003] ATP 28 at paragraph 49

¹¹ [2008] ATP 19

¹² under section 657A of the Act

¹³ [2008] ATP 19 at paragraph 11

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Where to from here?

The rationale for section 622 is to ensure that large shareholders in a potential target company are not unduly favoured over other smaller shareholders. However, where an escalator agreement simply ensures that a selling shareholder receives the same, and not more, consideration as other shareholders in a bid, the section 622 prohibition may be unwarranted.

In fact, in such circumstances, the prohibition could be adverse to the interests of all shareholders – both small and large – as it may impede the ability of a prospective bidder from building up a strategic stake in the target and, in turn, reduce the prospect of a bid ever being made. It might also be argued that substantial shareholders – by virtue of the size and hence value of their shareholding – *should* be entitled to a guarantee that they will receive the same consideration as other shareholders if a bid is made and where the only “net benefit” is mere early payment for their shares.

The prohibition on escalation agreements has been criticised by a number of bodies and commentators.¹⁴ In April 2006, the Financial Services Institute of Australasia (**FINSIA**) released a “Takeovers Package” setting out proposals to reform Australia’s takeovers regime to improve the market for corporate control, remove existing anomalies and protect the rights of minority shareholders. FINSIA noted that section 622 can restrict the method by which a person acquires shares below the takeover threshold of 20% in section 606, which at a policy level should be left unregulated. It was also submitted by FINSIA that escalation agreements can facilitate the acquisition of a pre-bid stake in a target company and assist the bidder in the process of establishing a bid. For these reasons, FINSIA considered that section 622 is now an anachronism (prohibiting an activity for which there is no mischief) and should be repealed.

In response to FINSIA’s “Takeovers Package”, the Law Council of Australia made a submission supporting the proposal to repeal the prohibition on escalators.¹⁵ In 2006 the Australian government also considered passing amending legislation to remove the ban on escalation agreements.¹⁶ Unfortunately, proposals to repeal section 622 appear to have been forgotten in the wake of recent new legislation prompted by the global financial crisis focusing on short selling, disclosure, margin lending, financial services and directors’ termination payments. Hopefully, a proposal to repeal the prohibition will re-appear on the government’s agenda in the near future. However, this may not occur until the current raft of amending legislation to the Act is finalised or until a high-profile case or strong lobbying raises the matter for the government’s attention once again.

In any event, the relevant cases suggest that the Courts and the Takeovers Panel will be reluctant to find that a genuine escalator agreement breaches section 622 or amounts to unacceptable circumstances where there has been no attempted or actual contravention of the Eggleston principles – in particular, the principle that target shareholders should all have a reasonable and equal opportunity to participate in any benefits accruing to shareholders under a takeover bid.¹⁷ Nevertheless, until such time as the Courts give further clarity or legislative amendments are made, proposed escalation agreements must be carefully drafted and structured to ensure they are not in breach of section 622 and thereby void.

¹⁴ See for example: Frith B. “Spotless bid a sign of volatility” 28 March 2008, *The Australian*.

¹⁵ Letter from Law Council of Australia dated 19 July 2006 addressed to Finsia.

¹⁶ Gettler L. “Rewriting the mergers and acquisitions rule book” 22 April 2006, *The Age*.

¹⁷ section 602(c) of the Act



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