DLA CLIFFE DEKKER HOFMEYR

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APPLICABILITY OF TAKEOVER LAWS TO SHARE BUY-BACKS

DUTIES AND POTENTIAL LIABILITY OF THE INDEPENDENT EXPERT

One of the key features that the Companies Act, No 71 of 2008 (Companies Act) introduced when it came into force in May 2011 is the substantially revised and simplified process for the implementation of a scheme of arrangement between a company and its shareholders (or other securities holders), in s114 of the Companies Act.

A scheme of arrangement is probably the most popular method utilised in practice to effect a takeover of a public, especially listed, company with a great number of shareholders, as the essence of a scheme is that if the requisite majority of votes can be obtained by way of a special resolution, the whole class of shareholders is bound by that arrangement and is thereby expropriated whether or not they voted in favour thereof. S311 of the previous Companies Act, No 61 of 1973 dealt with schemes of arrangement and entailed a meeting of shareholders and a strictly court-sanctioned process. The new scheme process does away with the requirement for a court order approving the scheme (unless dissenting shareholders compel a court review of the special resolution under s115(3)), and has replaced same with the requirement that an independent expert's report be prepared and circulated to the holders of the company's securities.

S114 provides that unless it is in liquidation or in the course of business rescue proceedings, the board of a company may propose any arrangement between the company and the holders of any class of its securities by way of a range of methods, namely:

- a consolidation of securities of different classes;
- a division of securities into different classes;
- an expropriation of securities from the holders;
- exchanging any of its securities for other securities;
- a re-acquisition by the company of its securities; or
- a combination of the methods contemplated above.

The scheme must be approved by a special resolution at a general meeting under s115, and the notice convening the meeting would typically include the expert's report.

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The independent expert would typically be a merchant bank or audit firm or other such institution that has the requisite expertise to opine on the financial effects, and fairness and reasonableness, of the proposed scheme. An interesting question which arises in this context is, what are such experts' potential liability and duties in respect of the report which they prepare and which is submitted to the shareholders? A recent March 2014 case in the Court of Chancery of the US state of Delaware has made some noteworthy points in this regard (*In re Rural Metro Corporation Stockholders Litigation*, CA No. 6350-VCL (Del. Ch. Mar. 07, 2014)). Given that the Companies Act has shown some leanings towards US law (particularly in the context of fundamental transactions), these principles may be very relevant and applicable in South Africa should a similar legal question find itself before our courts under the still relatively new and untested s114. The case specifically dealt with the expert's duty to avoid a conflict of interest and to provide truly independent and objective advice.

In the Rural Metro case, the court reviewed the validity of a 2011 merger between Rural Metro Corporation (Rural) and a company within the Warburg Pincus LLC group (WP). The plaintiffs (shareholders of Rural) contended that Rural's board of directors breached its fiduciary duties by approving the merger and failing to make material disclosures in its notice to shareholders (a 'proxy statement' as known in the US). They also claimed that RBC Capital Markets LLC (RBC), which acted as the financial advisor to the Rural board, aided and abetted the directors' breaches of fiduciary duties. Although the Rural board settled before the trial, the case proceeded against RBC as the financial advisors.

Before addressing the liability of RBC at trial, the court discussed the duties, role and responsibilities of financial advisors in the course and context of mergers and acquisitions, and the importance of holding them liable for aiding and abetting breaches of fiduciary duties. The court likened the role of the advisors to 'gatekeepers', and stated: "The threat of liability helps incentivize gatekeepers to provide sound advice, monitor clients, and deter client wrongs... [T]he prospect of aiding and abetting liability for investment banks who induce boards of directors to breach their duty of care creates a powerful financial reason for banks to provide meaningful fairness opinions and to advise boards in a manner that ensures directors carry out their fiduciary duties..." If a case were brought against an independent expert under the general principles of the South African law of delict, considerations such as these would undoubtedly be used in support of an argument that it is apt and reasonable to place a legal duty on the independent expert to provide a sound and objective opinion, failing which the expert should be held liable to shareholders for damages.

Accepting the existence of this fiduciary duty, the court found that RBC ignored multiple conflicts of interest in negotiating with WP on behalf of Rural. Specifically, the court found that while RBC was negotiating with WP, it was simultaneously trying to secure a role as financier of the acquisition, a fact it failed to reveal to Rural's board. More egregiously, the court found that at the same time RBC was attempting to convince WP to use its financing to make the acquisition, it was also revising its valuation of Rural downward. In other words, RBC, motivated by an opportunity to participate in the financing of the deal, intentionally and covertly made WP's bid look more appealing than it actually was by purposely undervaluing the company. Because these materially false valuations were included in the proxy statement, but not revealed to the Rural board, the court held that RBC prevented the Rural board from fulfilling its obligation to get the best price for its shareholders.

With the breach of duty established, the question then turned to the appropriate remedy and measure of damages to be claimed from RBC. However, at this stage of the trial the court did not have enough information regarding the fair value of the Rural shares, and ordered the parties to make submissions in that regard at a future hearing in order for the court to be in a position to quantify damages. In the South African law of delictual damages, for instance, the measure of damages awarded is calculated (subject to a number of qualifications and nuances) by comparing the present financial/ pecuniary position of the plaintiff, to the position in which he would have been had the damage-causing event (breach of duty) not occurred.

Companies that undertake schemes of arrangement, and particularly the experts they retain for this purpose, should take note of developments like this in the law pertaining to their potential liability to shareholders. The Rural Metro case is one of a number of interesting examples from abroad which may have some influence on our local laws.

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APPLICABILITY OF TAKEOVER LAWS TO SHARE BUY-BACKS

Regulated companies, as defined in s117 read with s118 and regulation 91 under the Companies Act, No 71 of 2008 (Companies Act), should always be mindful of the applicability of the takeover laws to share repurchases that fall under s48(8)(b) of the Companies Act, namely where the company intends repurchasing more than 5% of a class of its shares in a transaction or series of integrated transactions.

A 'regulated company' is either of the following:

- A public company. This is a company which does not have a restriction on the transferability of its securities or the memorandum of incorporation (MOI) of which does not prohibit the company from offering any of its securities to the public. A public company need not necessarily be listed on a stock exchange – the key question rather is whether or not its MOI contains the aforesaid restrictions. However, all listed companies are necessarily public companies because a company's listed securities must be freely transferable.

- A state-owned company. These are companies listed in schedule 2 or 3 of the Public Finance Management Act, No 1 of 1999, or companies which are owned by municipalities. These are commonly referred to as 'parastatal' companies which are owned by the State. Major state-owned companies include the likes of Eskom, South African Airways, the South African Post Office and the South African Broadcasting Corporation.

- Certain private companies. It is more often than not in the private company arena where the parties to a transaction sometimes overlook the question of whether or not the company involved is a regulated company and therefore whether the takeover laws apply. A private company is a regulated company if more than 10% of its voting securities were transferred in the previous 24 months amongst persons that are not related or inter-related as defined in s1 and s2 of the Companies Act. However, even if a private company does not fall within the statutory criterion of a regulated company, a private company may in terms of its MOI voluntarily submit itself to the takeover laws, although this is rarely seen in practice as the company and its shareholders would typically not want to be subject to an additional layer of regulation should a potential takeover be proposed in respect of the company.

The takeover laws apply where a regulated company undergoes an 'affected transaction'. These are listed in s117(1)(c) of the Companies Act and are, in basic terms, takeovers or mergers in respect of regulated companies. One of the affected transactions is a scheme of arrangement in respect of a regulated company (s117(1)(c)(iii) read with s114). It should be noted in this regard that where a company undertakes a share buy-back under s48(8)(b) of the Companies Act, that section provides that such buy-back is subject to s114 and 115 of the Companies Act. Since a scheme of arrangement under s114 in respect of a regulated company is an 'affected transaction', the same is subject to regulation by the Takeover Regulation Panel (TRP) and the TRP is required to approve all documents and circulars that are submitted to the shareholders. From a legal perspective one can argue both ways as to whether such a buy-back is in fact a scheme of arrangement, but experience has shown that the TRP's view is that such buy-backs are subject to the TRP's jurisdiction and must therefore be 'cleared' by the TRP prior to implementation, under s121 of the Companies Act (alternatively exempted under s119(6)).

Listed companies often include a proposed resolution in their notice of an annual general meeting (AGM) for a general buy-back of shares, under s5.72 of the JSE Listings Requirements. The maximum number of shares that may be repurchased per financial year is 20% (s5.68). This is simply an authority that is requested from the shareholders and it is at that stage not even certain if a buy-back will actually occur after the AGM, let alone whether any particular buy-back or series thereof would fall within s48(8)(b). However, note that if there is a possibility that the company will buy back shares as contemplated in s48(8)(b) (that is, more than 5% in a single transaction or integrated series), then that is still regarded as a scheme of arrangement and as an affected transaction, by the TRP.

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If a buy-back resolution is proposed by a regulated company and if it is anticipated that s48(8)(b) could apply, consideration should be given as to whether the AGM notice and the accompanying expert's report are to be submitted to the TRP under regulation 117 of the Companies Regulations, 2011, which provides that all documents relating to an affected transaction as defined under s117(1)(c) of the Companies Act, including announcements and circulars, must be approved by the TRP before being posted or published. Otherwise the company would have to go through all the necessary steps and send a circular to shareholders again at the time that it proposes to actually implement a s48(8)(b) buy-back.

As for the content of the AGM notice, the question arises as to what extent it ought to comply with the requirements of the takeover regulations pertaining to circulars and experts' reports. Regulation 90 deals with the prescribed content for experts' reports and regulation 106 deals with the disclosures that must be made in the circular. These are *inter alia* financial disclosures in relation to the company and its securities, interests held by directors, trading in securities by directors and the offer price in respect of the securities. It is certainly debatable to what extent regulation 106 can, in accordance with its terms, apply to scenarios where a general shareholder authority for a buy-back is being sought, as there is not at that stage any 'offer' made, and no offer consideration, in respect of the regulated company's securities, whereas regulation 106 refers to an offeror circular and an offeree regulated company's response circular.

Be that as it may, each case would have to be assessed on its own merits and the TRP should, in appropriate cases, be consulted for some guidance and advice on the required content of, and disclosures to be made in, the AGM notice. The TRP may require compliance with the content and disclosure requirements as far as is applicable to the matter. Alternatively, an exemption would have to be sought from the TRP on substantial and justifiable grounds. Either way, the TRP's involvement is a necessity in these cases, a fee is levied by the TRP in either case, and companies should be mindful of this potential regulatory step.

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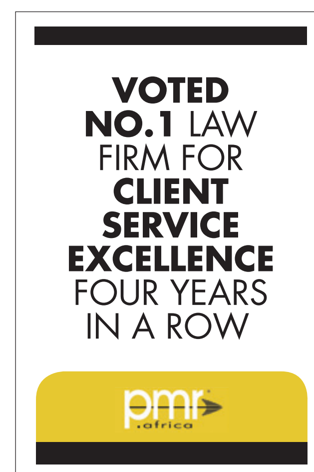

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