



EPISODE
135

THE DEAL ROOM

The serious traps in financing share acquisitions, with Robert Pacella

The Deal Room Podcast

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Transcript

Joanna: Hi, it's Joanna Oakey here and welcome back to The Deal Room podcast. A podcast proudly brought to by our commercial legal practice Aspect Legal. Now today we are talking all about the traps in financing share acquisitions and in order to talk about this topic, we have onboard our very own Robert Pacella from Aspect Legal. In this episode, Rob and I talk about the provisions of the Corporations Act that are perhaps forgotten by buyers when they are looking to use finance in share acquisitions.

We talk about the mistakes that are often made, the traps and how you can go about making the most out of exemptions that are available and some warnings when you're looking at using these exemptions to make sure they're actually working. All of this and more so buckle in. Here we go with Rob.

Rob, thanks so much for joining me on the The Deal Room podcast today.

Robert: My pleasure Jo.

Joanna: So let's get stuck into it. Today, we're talking about the traps in financing share purchases.

Robert: Yep.

Joanna: And so let's kick it off by just overview. What are the general traps that we see when people are looking at financing share purchases, I guess we're talking about today, stuff that isn't necessarily readily obvious.

Robert: So this subject comes out of a section of the Corporation Act which deals with financial assistance. So it's not just narrowly related to share purchasing. And when someone is financing share purchases, maybe bank loans or mortgages over the shares. It's actually wider than that. It deals with any situation where financial assistance is involved with shares.

So I'll give you two examples. That is the classic example where there's a maybe a leveraged buyout or there's a purchase of shares, which is using bank finance. And that is certainly financial assistance. There's money being brought in. And quite often the bank will need security over the shares in the company, which it's buying. That means that the the company itself has to offer security over the shares. And that might dis-entitle the existing shareholders to security that they would have had bought for the finance coming in on those shares.

So that's the classic example where you would hear the term whitewashing. For example, there's a process that you need to do with whitewashing and we would come back to that and talk about that at the moment. But there's other potential problems with financial assistance which don't come around from share purchases, but might just come around simply from how the company is operating. For example, there was a really interesting, interesting as a subjective word, really interesting.

Joanna: Haha that's because we are lawyers and we like cases.

Robert: Oh yes we do. So there was a really interesting decision made by the courts. And this one was nothing to do with financial assistance from a bank buying shares. This one was where you had a group of shareholders and the company in its constitution had a requirement that any shareholder that was exiting had to give the remaining shareholders the right to purchase those shares before that exiting shareholder could offer them to the rest of the world of third party. Right. So we had a situation where the exiting shareholder decided you didn't want to honor that right and wanted to sell to a third party. The rest of the shareholders decided that wasn't on. And the company itself then funded the legal process to prohibit that shareholder from selling its shares to the open market. And the exiting shareholder relied on the Corporations Act and said that was that the company funding the legal challenge that was offering financial assistance to the shareholders over his shareholders. That should have been protected under the part of the Corporations Act.

Joanna: And let's be clear. That then meant that the company and the directors who are acting for the company were in breach of the Corporations Act back then.

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Robert: Absolutely.

Joanna: You know, that's a really serious outcome.

Robert: Yeah.

Joanna: And what was the outcome in this particular case as a result of that?

Robert: Well, the outcome was that the directors themselves were open to sanctions. So that's that's something which is criminal sanctions apply to financial assistance. Where you're not allowed to provide the said assistance. So it opened up the directors to criminal sanctions. And they've also obviously freed up that shareholder to go off and do what he wanted to. Now, the share the company itself could have taken a civil action to do this on the side of things. But the point was that the high courts stepped back and looked at this and took the idea of financial assistance. Very broadly. So it wasn't just about a bank coming in offering money in return for security over shares in the company. It was really an operational decision that the company to provide money to what I think they thought at the time was a fair and reasonable purpose, which is to protect the rights in the Constitution. But as it turned out, its financial financial assistance.

Joanna: And to make it really clear, you know, because rights of pre-emption, you know, extraordinarily common, really common in shareholders agreements, quite often constitutions of organizations. And so in this case, the company was merely seeking to enforce the pre-emptive right where a shareholder had sought to act in breach of that obligation. It was just the mere fact that the company paid the legal fees. That meant that it was then in breach of the Corporations Act because it was providing financial assistance in relation to effectively the shades within its own entity.

And let's move one step back and go back to the Corporations Act provisions that we're talking about here. Maybe. Can you remind the listeners actually, who will care what sections of the corporations act it is? But how about we tell them anyway? I hear you as a listener, I really don't care what provision it is. But let us lawyers tell you. We lawyers let us just tell you what provisions of the court said.

Robert: Well, it's it's Part 2J.3, which is section two. Sixty eight onwards. And there's quite a few provisions that actually do that to J three to sixty eight. Part one talks about the three types of things that you can do to allow yourself to work around this restriction against financial assistance.

Joanna: And so firstly, the Corps act says, a company, is restricted in relation to providing financial assistance in relation to its own share. So that's the fundamental principle. And I think when you say that, it perhaps sounds simple on the surface, but it's super easy to fall foul of these provisions, as we just heard in this high court case. You know, just the mere payment by the company of the legal bills that related to enforcing the rights of the company against a shareholder that didn't comply with the preemptive right provisions under the Constitution, saw it fall foul of these provisions.

And so that's one example. And then in the M&A space that we work, I guess, and there's many examples, but perhaps another common example is where a buyer is financing the purchase of the transaction of backwards ition of shares in a company,

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and they give the lending facility of the lender a security over the company as a whole. That's right. For example, in their own fixed home funding charge or the new General Security Act wording.

Robert: Exactly. So the key to what it turns on, it's a prohibition when you're dealing with the acquisition of shares. So in the first instance with that case, although it was the company just paying for legal support and so forth, the whole matter was tightening on who was acquiring them shares. Was it the pre-emptive rights holders or was it the third party? But the fact of the matter was it was about someone acquiring shares. So that was what that was about on the classic case, which is whitewashing, which is what you were just talking about then a lender coming in and funding someone who is acquiring shares. And as a consequence of that, a lender wants to protect itself and it wants to take security over the shares or over the company, like the fixed and floating charges and so forth, or debentures. And that is, again, obviously acquiring shares.

So it's really a general prohibition as soon as you're talking about acquiring shares. However, that might happen where there is some type of financial assistance being provided by the company or by a lender or really anything that would impact the potential rights of the other shareholders in that business. That's the provision.

Joanna: And so I think the warning is here. If you are a buyer of shares in a company or a you are assisting in a professional capacity in an acquisitions. I say, for example, you're an accountant or a broker or a corporate adviser who is assisting a buyer in a share acquisition. You just need to be aware of the risks where there's finance involved, which quite often there is, you know, in very large proportion of cases, there's finance involved.

And make sure you've got the right legal advice to understand whether or not you're at risk of falling foul of these corporation act provisions because they're really serious.

Robert: They are. They impact and entitle the directors of the business of the company, which is providing the guarantees for the bank. So if it's a target company and they're looking to get an investor in and they're selling some shares to that investors and the investors funding. Then the director/directors of the target company potentially face sanctions under the Corporations Act if they allow financial assistance and it's not under these exemptions in the Corporations Act.

Joanna: I'm glad you mentioned the exemptions Rob. How about you take us very briefly through. Just headline what the sort of exemptions that we can think about, because, you know, I don't want you listening audience to have now the fear of God through you being concerned that you're no longer able to finance acquisitions. That's not the case. It's just that you need to be wary where acquisitions of shares being financed and understand whether any of these issues are triggered and if they are, understand which exemptions to apply. So let's just give you a headline intro into what these exemptions apply.

Robert: There are three first exemption is where you can demonstrate that the assistance given doesn't materially prejudice the interests of the other shareholders. Now, that's more of a subjective thing. That's to do with the balance of what you can reasonably show that there was no issues at the generated share. That's not usually

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used very often. There's a general exemption under section 260 C the Corporations Act, which is the real umbrella to be technical exemption, which I'll skip over the one which mostly it's focused on is Section 260 A1B, which is where the assistance is approved for the shareholders of the company.

So in other words, all the shareholders of the company get together and agree at a general meeting or via a second resolution that giving financial assistance is okay by them and they consent to that. And that is the essence of the whitewash process. All parties agree that it's fine by them. And obviously, there's a there's a process involved and that's the most used.

Joanna: Yes, and I wanted to point to that as well, because in essence, the conceptually it's simple in process, here's quite a bit to do, isn't it?

Robert: It is.

Joanna: And you know, there's important timing requirements. There's lodgement requirements. There's meeting requirements. And all of these needs to be done in the right, ordering the right time because failing to meet some of the timing requirements can be massively problematic in this area.

Robert: Yeah, absolutely. And if you fail to meet the timing requirements, then the entire process that you have started out doing and performing can simply evaporate. It can just be held to be invalid, because unless you make these days the statutory time requirements, unless you make me strict about the entire process, can be voided. And if it's a whitewash process, for example, where you're getting all the shareholders to agree that this giving a financial assistance is OK and you miss the timing of it, by even one day, it's void.

You can't rely on that.

Joanna: Yeah, that's such an important point. I just want to emphasize that you missed the timing by one day. It's void. You can't rely on it. So this is we say, you know, the process is critical. We mean it. We're not kidding.

Robert: Yeah, absolutely. And this is more complicated than just standard resolutions, because not only are there statutory timing requirements and there are things you have to hit. There was information you have to actually give to your shareholders and all sorts of documentation. But in the middle of all is to prove that you've hit these timing requirements, you need to be filing documents with ASIC waiting classic actually acknowledged or until you can deem it acknowledged before you can take the next steps and its timing requirements, not only things that are in your hands, but you've also got to take into account that you must hit certain timing requirements and then you have to deal with ASIC.

And only after that you can move to the next step. And there are several steps where you need to involve ASIC. So it is quite a complex process.

Joanna: Right. All right. Well, I think we've given a really good summary. And let's maybe wrap around the two main arms of these provisions in the Corps Act again, Rob.

Robert: The key to it is that this is a general focus on anytime financial assistance turns on acquiring shares in the company and whether that is acquiring shares preemptively based on an exiting shareholder. If, for example, the company is trying to enforce one shareholder's rights and it's paying for legal bills in the high court case, that's enough, because as long as the company is providing some financial assistance, whatever that might be, that actually aids one shareholder over another. That's financial assistance. And the other arm would use when you are acquiring shares in a company and potentially there's a lender involved. And that lender wants security. And the company needs to give security. That's financial assistance.

Joanna: Brilliant. Excellent summary, Rob. Thank you so much for being on the Deal Room podcast today. It's been a pleasure having you here.

Robert: tMy pleasure Jo.

Joanna: That's it for this episode of The Deal Room podcast, obviously, where we have been talking about the traps in financing share purchases. Now, if you'd like more information about this topic, just head over to our Web site at thedealroompodcast.com, where you'll be able to download a transcript of this podcast episode.

If you'd like to read it in more detail there. You'll also find details of how to contact Rob and any other of our legal eagles at Aspect Legal. If you would like assistance with your organization or with any of your clients, if they're looking, if you or they are looking at the acquisition of shares and are looking at financing the transaction and want to make sure that you're keeping out of trouble. And finally, if you enjoyed what you heard today, then please pop over to Apple podcasts or your favorite podcast player.

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