Deals

Exam notes

Structuring an acquisition

Share or asset purchases

- In an acquisition, the acquirer seeks the transfer of the ownership of a business. Corporate owners of businesses merely act as a vessel to transfer a business — a collection of assets, processes, staff and intangibles — from one owner ('the target') to another ('the acquirer') (Magarey).

- There are two principal ways in which an acquisition may be structured: (**1**) a business acquisition of the assets, or (**2**) a sale of all the issued shares in the company that owns the business.

    - The choice between share sales and asset sales is <u>not</u> available where the business is owned by a natural person, rather than by a corporate body. If there are no shares issued, a share sale is not possible.

- The two approaches and advantages and disadvantages, and the approach take in a given acquisition will depend on a range of considerations.

    - In general, **share sales** are a straightforward method of acquisition which is cleaner for the seller; achieve greater business continuity (Magarey); are less likely to involve the consent of third parties; are less likely to incur complex tax issues (no stamp duty); and are unlikely to give rise to difficulties concerning intangible assets such as contractual rights which might otherwise need to be novated. <u>*Share sales may need to consider the company's constitution to determine whether any preemptive rights exist.*</u>

    - In general, **asset sales** may be more beneficial in terms of tax implications; the purchaser is free to pick and choose which assets are purchased (while in a share sale, all assets of the relevant company will be transferred) (Magarey); preferred method of transfer for an acquirer wishing to incorporate assets of the target into the acquirer's business; and purchasers avoid any liabilities that may be owed by the target company (for example, claims against the target company in tort).

- Both approaches require **due diligence**. Share sales require significant due diligence of the assets and liabilities of the target company, particularly with respect to liabilities and obligations that the company owes. Asset sales require due diligence to ensure that the purchaser 'gets what they are paying for': there is very little statutory protection of buyers in a commercial context (except as provided by the ACL), and the rule of *caveat emptor* applies.

Considerations	Asset sale	Share sale
Tax or duties	• Taxes generally higher on the sale of assets • Stamp duty incurred on any transfer of land ownership under *Duties Act 2000* (Vic)	• Stamp duty generally not incurred as no assets are transferred per se, only the identity of the owner • Capital gains tax is incurred, but this is generally preferable to stamp duty
Operational and licensing requirements	• Any change in control of assets may require new licences, and incurring associated fees	• Licences for assets and equipment will attach to the company, if owners of company are all that change there is no need to secure new licences
Unwanted assets or businesses	• Benefit of asset sale is purchaser is able to pick and choose which assets it wants and which ones it doesn't	• Disadvantage of share sale is having top purchase all assets owned by the target • May be resolved through divestment in unwanted assets
Convenience	• Less convenient than a share sale: must identify all assets individually, adding to due diligence risks and costs	• More convenient than an asset sale
Intangibles	• Similar problem as above: must individually identify all intangibles that are to be included in the asset sale • For contracts, assignment must be effective per s 134 of the *Property Law Act 1958* (Vic) • This is demonstrated by the *Pacific Brands* case study	• Intangibles are all owned by the company running the business; no problems associated with contractual assignment or identifying specific intangibles
Exposure to liability	• Less exposure to unforeseen liabilities; this is associated with being able to pick and choose assets for purchase	• Risk of taking on unforeseen liabilities of the target • May be resolved through use of indemnities
Business continuity	• Less smooth as compared to share sales	• More smooth as compared to asset sales
Valuation	• More difficult to value assets on their own as their value may change depending on who owns them	• Easier to value assets held by the company because the owner of the assets is not changing (but the ownership of the company is)

Assets

- Assets refer to an economic resources that is capable of being owned or controlled to produce value. Assets are classified in two categories: (**1**) tangible; and (**2**) intangible.

Tangible

- Tangible assets are those that have a physical substance such as **currencies**, **buildings**, **real estate**, **vehicles**, **equipment** and **stock**. The key tangibles are **property, plant and equipment** (PPE).

Intangible

- Intangible assets are those which lack physical substance such as **intellectual property, contractual rights, patents, brand names and goodwill**.
    - Goodwill is the value placed on the business over and above the value of all other assets which has come about through the reputation of the company, and its relationships with customers, suppliers and staff. Goodwill cannot be bought, though it may appear on a company's financial statement.
    - The assignment of contractual rights — perhaps the most valuable intangible asset — is particularly important.

Assignment of contractual rights

- Section 134 of the *Property Law Act 1958* (Vic) allows for the assignment of things in action: a thing, or 'chose' in action is a **species of property that cannot be possessed and may only be recovered through legal action**.
- A chose in action includes 'a debt, a right of action on a contract and a right to damages for its breach' (*Pacific Brands*, Finkelstein J [9]).

Section 134 — Legal assignments of things in action

Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, shall be and shall be deemed to have been effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice—

(a) the legal right to such debt or thing in action;

(b) all legal and other remedies for the same; and

(c) the power to give a good discharge for the same without the concurrence of the assignor:

Provided that, if the debtor, trustee or other person liable in respect of such debt or thing in action has notice—

(a) that the assignment is disputed by the assignor or any person claiming under him; or

(b) of any other opposing or conflicting claims to such debt or thing in action—

he may, if he thinks fit, either call upon the persons making claim thereto to interplead concerning the same, or pay the debt or other thing in action into court under the provisions of the Trustee Act 1958.

- Section 134 provides that in order for a chose in action to be assigned at law (as opposed to in equity), **notice must be given to the debtor, trustee or relevant liable person**. This allows the assignee (the recipient of the assignment) to step into the shoes of the assignor and enjoy the associated rights and remedies.
    - For example, a debtor and creditor may enter into a contract creating a debt. Under the contract, the creditor has a right to claim the amount of the debt from the debtor. If the creditor wishes to sell this contractual right (or 'chose in action'), the creditor may assign the rights under the debt-creating contract to a third party. Section 134 provides that so long as certain conditions are met — that the assignment is absolute, in writing, and with notice to the debtor — the assignment of the chose in action will be effective at law from the date that notice is given. Now, the third party has all of the legal rights and remedies of the original creditor.
- The section is significant, as it means assignees need not go through the assignor to assert a proprietary interest. Asserting a proprietary interests — particularly in the event of an insolvency — is important, as **it will give the assignee a proprietary claim which will defeat the claims of other creditors**.
- If the conditions of s 134 are not satisfied, it does not make the assignment invalid. However, for the assignee to sue at law 'he must enlist… the assistance of the assignor' (*Condor Asset Management*, Barrett J [24]). In *Long Leys Co v Silkdale*: 'Where the assignment of legal property is <u>only</u> equitable the assignor generally remains a necessary party to any action to enforce the interests assigned and the assignee is entitled to require him to be joined or to sue in his name' (Sheller JA).
- Some contracts purport to prohibit the assignment of contractual rights.
    - In the United States, legislation invalidates such clauses on the ground that they constitute a restraint of trade.
    - In England, such clauses are valid and will be full effect by the courts (*Linden Gardens Trust*). This will render any purported assignment ineffective.
    - In Australia, the position is not settled (*Hall v Busst*), however a number of courts have expressly adopted the reasoning in *Linden Gardens* (*Don King Productions*; *Devefi Pty Ltd v Mateffy; Pacific Brands*, Finn and Sandberg JJ). Until such time as the High Court has an opportunity to establish clear authority, the reasoning of *Linden Gardens* will be applied in Australian courts (Tolhurst).

Case Study: Pacific Brands

- Saramar (licensor) owned trade marks in King Gee and Stubbies. Saramar licences to Sara Lee (sub-licensor), and Sara Lee sub-licences to Underworks (sub-licensee). In this sub-licence, Sara Lee has a right to unilaterally terminate upon any breach by the sub-licensee. Later, Sara Lee's rights were assigned to Pacific Brands, which then purported to terminate Underworks' sub-licence.
- At issue was whether Pacific Brands had the same right to unilaterally terminate for breach, and if so, whether it exercised that right lawfully.

- Pacific Brands argued that the sub-licence was assigned to it and as a consequence it stood in the shoes of Sara Lee.

Trial decision

- At trial, Finkelstein J held that 'plainly this is incorrect' (it is not possible to substitute parties to a contract in the absence of novation, and novation requires the consent of the parties), and that in any case, a right to recession is 'incapable of assignment' [17]. Finkelstein J characterised a right to rescind as a 'purely personal right', and not as an assignable chose in action. Accordingly, there was no right to terminate as there was no assignment or novation.
  - If you look at property as a bundle of rights, some rights will be assiganable while others will not be assignable. Finkelstein J held that the right to terminate was a personal right incapable of assignment.

Appeal decision

- On appeal, Finn and Sundberg JJ upheld the trial decision but disagreed with Finkelstein J's analysis that the rights were not fundamentally choses in action. Finn and Sundberg JJ held that it was inappropriate to categorise rights as either assignable or unassignable. Instead, **regard must be had to the nature of the contract and the subject-matter of the contractual right in question**.
  - If that right is personal — that is, <u>*the identity of the obligee is material to the contractual relationship*</u> — then the right will <u>*not*</u> be assignable (*Peters v General Accident*)
  - A right will <u>not be personal</u> if, construed in its setting, it can make no difference to the person on whom the corresponding obligation lies.
- Finn and Sundberg JJ held that novation would circumvent all of this — because novation is the creation of *new* rights and obligations (*Olsson v Dyson*) — but this would require the consent of the other party, which had not been granted in the circumstances.
- In sum, **all rights are prima facie assignable, but in some cases where the right is 'personal' in nature**, it may be unassignable.
  - Key point of difference to Finkelstein J's reasoning at trial is that rights may not be rendered 'unassignable' due to their status as property. The correct approach, according to Finn and Sandberg JJ is to assume <u>all right as assignable</u>, unless the right is personal in nature.

Shares

- Shares are a species of intangible property consisting of rights and obligations relating to a company but <u>not</u> constituting a debt. A share is a chose in action.
- Following *Gambotto*, shares are said to confer proprietary rights.
  - The *Gambotto* decision generated considerable academic debate on the meaning of proprietary rights (see below).

Gambotto — IEL owns 99.7% of shares in WCP; Gambotto and others own 0.07% of shares. Under the provisions of the Corporations Act, large shareholders can expropriate shares throughout either a scheme of arrangement (s 414) or a takeover bid (s 701), but neither option was open to IEL. Instead, IEL amended the Constitution to give it the right to acquire shares at $1.80 per share.

At trial, McLelland J held that the ability to amend a company's constitution was contained by equitable principles, and that accordingly, the exercise of power in this case was unduly oppressive.

On appeal, the New South Wales Court of Appeal overturned the decision of McLelland J and held that the Corporations Act allowed the expropriation of minority shares. Meagher JA noted that while in some cases this would be unjust, there were considerable benefits of the expropriation of shares if acquired for a fair price.

The High Court overturned the Court of Appeal and held that the amendment was not made for a proper purpose. Although the rights associated with shares may be altered through constitutional amendment, the power to amend the constitution cannot be exercised without regard to the object of the power: it must be exercised for a proper purpose and its exercise must not be oppressive to minority shareholders. In this case, the High Court clearly referred to shares as a proprietary right: '… this approach doe not attach sufficient weight to the proprietary nature of the share…". **A share is property, and it cannot be appropriated without consent.**

- Following *Gambotto*, the Corporations Act was amended to include Part 6A.2. This allowed shareholders who owned 90% or more of the issued shares of a company to, within six months of obtaining that volume of shares, acquire the remaining shares without having to go through a formal takeover bid or share sale agreement.
- **A share is, for most purposes, a proprietary right. This informs the remedies that are available to protect the right, such as the remedy of specific performance.**

Academic debate following *Gambotto*

- Ramsay and Saunders note that one of the most important aspects of the decision in *Gambotto* was the court's conception of shares as 'items of property which have intrinsic value in addition to their monetary value'. The authors note that many academics rejected this conception put forward by the High Court.
    - Kevans argued that it was **not appropriate to conceive of shares as property** where most shareholders were 'passive investors with no expectation of participation'.
    - Walton dismissed the arguments of the Court, stating that any **entitlements attaching to shares are defeasible** and therefore not characteristic of property.
    - Bird argued that the **power to alter the constitution of the company means that any right that it confers on shareholders are defeasible**.
    - Elliot contended that to conceive of shares as property would limit expropriation which, where a fair price is paid, is entirely appropriate.
- On the other side, some commentators defended the decision of the High Court. McConvill rebuked the arguments of those criticising the court by arguing that the fact that the assets of the company are separate from those of the shareholder does not preclude the shares being characterised as property. Spender

concluded that shares should be characterised as property, **noting that defeasible interests may still be proprietary** (cf Walton and Bird above).

- Chambers engages in the debate by evaluating the nature of the rights that are associated with share ownership. He begins by noting that s 1070A or the *Corporations Act 2001* (Cth) refers to shares as 'personal property', but find this not to be determinative
  - **Right to vote at general meeting** — Chambers argues that this is the right that most resembles a proprietary right; 'the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage (*Peters American Delicacy*, Dixon J); but there are also problems with referring to the right to vote as a proprietary right: it is a right that may only be exercised against the company, not third parties; control through votes is only ever indirect.
  - **Right to receive dividends as declared by the company** — this particular right is a personal right that may be enforceable against the company; it gives the shareholder a mere expectancy that a dividend will be declared, and that if it is, it will be paid to the shareholder in accordance with rights under the company's constitution.
  - **Right to share any assets of the company upon its winding up** — while the company continues to 'exist', shareholders have no rights to the property of the company; however, when the company is wound up, shareholders are entitled to any assets which remain after debts are paid. Chambers regards this not as a proprietary right, as it is not a right to anything while the company is ongoing.

Implications

- It may be concluded from Chamber's assessment of the nature of shares that it is difficult to conceive of shares as 'property' in the traditional sense.
  - Shareholders have no *direct* control over the company and no absolute certainty in receiving profits through dividends.
  - Shareholders *do* have a right to the proceeds of the company following its winding up, but there is a merely an expectance that is, in practice, often undermined by existing creditor claims against the company.
  - It is therefore difficult to treat shares as a type of property.
- If shares are *not* a form of property, how does the doctrine of conversion apply? Does the purchaser of share obtain equitable ownership of the shares when there is an enforceable share sale agreement awaiting completion? Can a purchaser demand specific performance of the SSA or claim the proceeds of a sale to a third party on constructive trust?
  - See *Luxe Holdings* below.