Australia’s Eggleston principles in takeover law: Social and economic sense?

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Australia has yet to give up its distinctive approach to take-over law. Although there has been and continues to be pressure to submit to the US model, this article argues that to do so is not likely to produce the desired effect while giving up something of particular value to Australians.

Introduction

In 1967 the Standing Committee of the Attorneys-General appointed a law advisory committee on company law. The chair of the committee was Sir Richard Eggleston. The committee was given the mandate to ‘inquire into and report on the extent of the protection afforded to the investing public’.1 The committee delivered seven interim reports many of which were later implemented in various pieces of legislation. Given the mandate, it is unsurprising that the Eggleston Committee, as it came to be known, and its reports developed a strong emphasis on furthering protection of the investing public.

It became increasingly obvious that the investing public needed protection over the years subsequent to the appointment of Sir Eggleston, as mining booms carried the Australian stock markets to new highs, even while stock manipulation, insider trading, and other abuses were rampant. One well-known example of Australia’s stock market mischief is the disclosure made by Senator Lionel Murphy in the Senate concerning an insider trading complaint reported to the Perth and Adelaide stock exchanges but which resulted in no action being taken.2 In response to this disclosure, the government set up a new commission which resulted in the Rae Report, released in 1974.3 The Rae Report was a scathing commentary on Australia’s exchanges, State legislation and enforcement agencies.4

It was in this historical context that the Eggleston Committee’s Second Interim Report identified four principles that came to be known as the Eggleston Principles regarding takeovers of public companies. They are:

1. that his [sic] [the bidder’s] identity be known to the shareholders and directors;
2. that the shareholders and directors have a reasonable time in which to consider the proposal;

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1 Quoted in Ford’s Company Law, [please provide publisher details] para 2.1.0105.
2 Ibid.
4 Ford, above n 1, Rae Report, ibid, along with other reports and investigations played a role in bringing the ASX to its current form as a for-profit, demutualised market owning corporation. See F Donnan, ‘Self-regulation and the Demutualisation of the Australian Stock Exchange’ (1999) 10 Aust Jnl of Corp Law 1.
that the offeror is required to give such information as is necessary to enable shareholders to form a judgment on the merits of the proposal and, in particular, where the offeror offers shares or interest in a corporation, that the kind of information which would ordinarily be provided in a prospectus is furnished to the offeree shareholders, and

(4) that so far as is practicable, each shareholder should have an equal opportunity to participate in the benefits offered.\(^5\)

These four principles are considered to be the drivers of Australia’s takeover legislation and embodied in s 602 of the Corporations Act 2001 (Cth).\(^6\) This article will critically consider the section, its social objectives, the economics of takeovers, and the conflicting economic and equitable objectives of the section. It will conclude with a brief consideration of the continued role of the section in Australia’s takeover law.

**Section 602 of the Corporations Act**

This section of the Act is remarkably faithful to the Eggleston Principles. With minor modifications to include holders of ‘interests’ and not just shareholders, the principles make up s 602(b)(i)–(iii) and s 602(c). Given the intervening years between the delivery of the report and the subsequent changes of government, the Eggleston Principles must have considerable general appeal to have survived. Commentators suggest that these principles reflect a peculiarly Australian ethos of ‘a fair go for all’\(^7\) — essentially creating an opportunity for all participants to share in a windfall.

Standing alone and somewhat disconnected amidst these equitable principles of s 602 is the apparently obvious and seemingly innocuous statement that the bid should take ‘place in an efficient, competitive and informed market’.\(^8\) In other words, the market must operate efficiently without unnecessary costs, have sufficient access to players, and parties should have information. We will return to consider this subsection in greater detail in the discussion concerning the economics of takeovers.

**Social aspects of takeover legislation**

Australia is unique among developed nations in even raising the notion of social aspects of takeovers.\(^9\) Although the breadth of the social element is quite limited — instead of including such things as employee lay-offs, or community damage by plant closings\(^10\) — it is limited to shareholders. Nevertheless, it at least considers in a principled manner the broader investing public in takeovers.

There are two social aspects considered by s 602, both in favour of the

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\(^6\) Ford, above n 1, para 6.2.0005.


\(^8\) Section 602(a).

\(^9\) Mannolini, above n 7, at 337.

\(^10\) Such social costs are a concern identified in s 636 where bidders must disclose any proposed changes to targets after acquisition which might include such actions as selling off assets and plant closings.
smaller shareholder. The first aspect, found in s 602(b), is that although the smaller shareholder does not have the power to force a bidder to disclose what it would pay for control of a corporation, the section does force the bidder to provide this disclosure. The legislation forces bidders to disclose to all interested shareholders and interest holders what the proposed consideration is instead of just disclosing it to the controlling shareholders of the target. This power to force bidder disclosure is not limited to parties wealthy enough to be able to undertake or be subject to a private bid.

The second social aspect of the section is in s 602(c). This subsection reads:

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 subsection requires the benefits of a takeover bid to be distributed equally among all shareholders.\(^\text{11}\) In other words, the premium for corporate control will not be limited to that group of sellers holding the controlling block of shares.

### Economics and takeovers

The economics of takeovers are both controversial and well-studied.\(^\text{12}\) Given the significant consequences of takeovers, both economically and socially, as well as the important role of economics in the development of policy, there are competing views about whether and how takeovers should be regulated.

The basic notion is that takeovers serve an important function in a market economy. The theory is that some corporations — where the corporation is viewed as a finance vehicle\(^\text{13}\) — provide a better rate of return. Obviously, such corporations are more attractive to investors. The reason attributed to such better rate of return is better management. Although certainly there are other factors involved, including the overall performance of the economy and the associated risks of a particular industry, at least on the basis of within industry comparisons, a credible argument can be made to credit superior management for the difference between corporations. Accordingly, corporate control transaction theorists suggest that by placing a poorly performing corporation into the hands of more efficient managers, the corporation’s returns will improve.

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11 City Code General Rule Number 1 of the City of London requires the same thing: equal treatment of all shareholders of the same class. Noted in Mannolini, above n 7,at 357.


Mannolini argues that M&A activity is increasingly being driven by access to liquid markets. Mannolini, above n 7, at 354–5. He notes also at n 93 the argument that takeovers are driven by executives trying to improve their salaries citing N Watson, ‘Efficient Markets, Hubris, Chaos, Legal Scholarship and Takeovers’ (1989) 62 St John’s L R 511.

13 As opposed to a social entity. F Easterbrook and D Fischel, The Economic Structure of Corporate Law, [please provide publisher details], p 10 write: ‘The corporation is a financing device and is not otherwise distinctive.’
Not every shareholder can engage in a takeover. To do so one must be knowledgeable in selecting a corporation as a potential target, knowledgeable about management, takeovers, and perhaps most importantly, have the financial wherewithal to do so. The sums involved in takeovers are enormous. Accordingly, only a very few wealthy individuals and other substantial corporations have the sums necessary to engage in takeovers of public companies.

From an economic perspective, the objective of all society’s activity — including corporate control — is to increase the overall wealth in an economy, and one way to do so is to improve the efficiency of assets. From this perspective, corporate control transactions are to be encouraged as one means of increasing society’s overall wealth.

In the economic paradigm, the only way to encourage someone to act is by financial incentive. Accordingly, from an economic standpoint, what is necessary is to provide financial incentives to those parties with the resources sufficient to undertake takeovers to do so. This economic perspective would leave disposition of the control premium as a matter to be determined by the parties to the transaction — in this case, those wealthy and powerful enough to take over a corporation.

Disposition of the control premium is a distributive matter, not an efficiency matter. Distribution, for most economists, is a secondary concern which follows efficiency both in theory and in practice. It is best left to taxation and social programs and, so in the corporate realm, to concern oneself with the distribution at the time of efficient wealth generating transactions is counter productive. This separation of efficiency and equity is known as the Second Theorem of Welfare Economics.14

There is another equally important theory of economic efficiency with bearing on both transactions and distribution. That theory is the Kaldor-Hicks theory of efficiency.15 It states that transactions in which overall wealth is increased should be conducted regardless of distribution or even consent of the parties.16 Further, Kaldor-Hicks efficiency does not require any payment of compensation to losing parties, as to do so may inhibit the wealth creating transactions from occurring.

In this sense, economics is a problematic discipline. It easily strays from its claim to be a science where one accepts science as a descriptive or heuristic activity. Whereas traditionally sciences refrain from providing normative prescriptions, economics as a discipline moves beyond describing economic phenomena and engages in advising as to what and how society ought to be ordered. Kaldor-Hicks efficiency is an economic theory that has such normative implications and, as will be seen, has a direct application in the takeovers context. Kaldor-Hicks efficiency suggests that to fail to engage in wealth creating transactions, is to fail as a society to create the greatest possible good, the greatest overall wealth in a society.

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16 Ibid.
In a takeovers context, Kaldor-Hicks theory has some significant consequences. For example, even though minority shareholders may lose a considerable part of the value of their shares in a change of control transaction, if there is an overall increase in the value of the corporation, from a Kaldor-Hicks efficient perspective, the transaction should be done and any gain may be kept by the winner without compensation to the loser in the transaction.\textsuperscript{17}

Economists, therefore, would oppose any measure which would impede Kaldor-Hicks efficiency in change of control transactions by distributing benefits of the transactions beyond the players who can undertake a wealth creating transaction. A wide distribution of change of control benefits is likely to dilute the benefit for the potential bidders to the point that the number of appealing transactions is lessened considerably.\textsuperscript{18}

Accordingly, the statement in subs 602(a) that the bid should take ‘place in an efficient . . . market’ is problematic in terms of the Eggleston Principles. What this subsection means is unclear: at least if it means Kaldor-Hicks efficiency, it cannot be in accord with the Eggleston Principles. In fact, it is difficult to see how the Eggleston Principles are ‘efficient’ in any sense of the word.

Economics of the Eggleston Principles

The first three of the Eggleston Principles concern information. To the extent that they reduce information asymmetry, they certainly touch on one of the central problems addressed by economists.\textsuperscript{19} Further, as the equity markets function to a large degree as sources of information,\textsuperscript{20} information recommended by the Eggleston Principles is a boon to the efficient operation of the market.

It remains questionable, however, whether the information demanded by the bidder and required of the target would not be available to the bidder in any event should a takeover be initiated even if there were no law addressing disclosure and to imagine a party willing to bid for shares without sufficient information to know whether the bid is reasonable or even worth considering in the first place. Essentially, disclosure of such information is the objective of Australia’s disclosure regime in any event. Thus, the additional disclosure required of bidders is uneconomic in the sense that it imposes a greater burden on bidders, and delays transactions. Although one may argue that it permits other potential bidders to make bids, there are certainly other ways that objective can be attained.

\textsuperscript{17} Such control transactions occur in an unregulated market where a change of control premium is kept exclusively by controlling shareholders and minority shareholders lose protection or power.


\textsuperscript{20} Information as a function of the equity markets is dealt with in H Houthakker and P Williamson, \textit{The Economics of Financial Markets}, \textit{[please provide publisher details]}, 1996, pp 130–41. Note that the relationship between efficiency and investor confidence is weak at best. See Explanatory Memorandum accompanying the Corporate Law Economic Reform Program Bill 1998, at paras 2.6 and 2.10, cited in Mannolini, above n 7, n 106.
As to the economics of the last of the Eggleston Principles, as indicated above, it is counter economics or promotes inefficiency, at least in terms of Kaldor-Hicks efficiency.

Conclusion

This clash of economic and social principles concerning takeover regulation brings the discussion back to the basic debate among legal scholars: should law be guided by principles of equity or principles of economics? Australia, by its Eggleston Principles, has demonstrated traditionally a preference for equity; however, its Corporate Law Economic Reform Program (CLERP) suggests a move toward economic based regulation. While the two combined — that is the Eggleston Principles and CLERP — may well provide a sound economic and social base for takeover legislation, the conflicting demands of equity and economics need to be given greater consideration, and a clearer policy set. On the one hand, the legal profession and Takeover Panel are moving toward an economic solution as ‘transaction cost engineers’. On the other hand, Australia does have something worth preserving in its equitable concerns. The measure of a society is not its efficiency and, until such is the case, the introduction of equity, even in its regulation of activities in its financial markets, is a valuable reminder of the overall values of a society.

21 This is the debate carried on between law and economics scholars and jurisprudential scholars. Perhaps the leaders of the debate, or at least the most vociferous and bellicose, are R Dworkin and R Posner. See R Dworkin, ‘Darwin’s New Bulldog’ (1998) 111 Harv L Rev 1718, in reference to Posner, and in reply, Posner’s characterisation of his opponents’ academic enterprise as ‘prissy, hermetic, censorious, naïve, sanctimonious, self-congratulatory’: R Posner, ‘1997 Oliver Wendell Homes Lectures: The Problematics of Moral and Legal Theory’ (1998) 111 Harv L Rev 1637 at 1640.