Appraisal of mandatory takeover offers under Investment and Securities Act 2007

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Introduction

Many legal advisers, professionals and investors interested in the Nigerian capital market must be aware of the enactment on June 2007 of a new Investment and Securities Act (ISA 2007) to replace the pre-existing 1999 Act. The new Act was a product of a long process of consultation, all aimed at addressing some of the obvious (and not so obvious) gaps in ISA 1999. Beyond the filing of gaps, the need for a new and improved law for the capital market was made more acute by the necessity of bringing our capital market law up to date with the position and trend in other jurisdictions. Law, as they say, is like a traveller who must be ready for tomorrow and must adapt to changes.

Among a number of innovations, ISA 2007 introduces an entirely new regime for mergers in its Part XII. This is by way of categorisation of mergers into three (small, intermediate and large), under distinct approval frameworks. Mergers are largely voluntary in the sense that parties intending to undergo mergers would have contemplated beforehand the need for them, the attendant legal and economic risks and all relevant implications before proceeding. That is not so with an ordinary investor whose motivation most of the time is simply to improve or increase his or her portfolio of a particular stock; and as long as the investor just does this, he or she was in no way legally obliged to undertake a take-over or absorption of the entity whose stock was considered attractive as to inform an increment in holding. All these appear to have changed with the introduction of mandatory take-over obligations under Section 131 ISA 2007.

This article is prepared to generate discussion on the dynamics and workings of Section 131 ISA 2007, and by extension, other controversial provisions of ISA 2007. The need for this contribution has been inspired by our realisation of the relative ignorance palpable among both colleagues and clients on the policy underpinning of a provision such as Section 131 ISA 2007.

In particular, however, we note from The Guardian of Tuesday, December 2, 2008, that Bank PHB has launched a N21 billion mandatory take-over bid for Spring Bank Plc under Section 131 of the ISA 2007.

Although we know from experience that a few companies have had a couple of brushes with the Securities and Exchange Commission (SEC) over the provisions of Section 131 ISA 2007 (some of which companies we were privileged to have advised), the Bank PHB development is quite remarkeable being the first time that a company on its own is coming under Section 131 to voluntarily make a mandatory take-over bid for another entity, as opposed to the previous situations when companies which unwittingly crossed the threshold, were required by SEC to make mandatory offers, but had to beat a hasty retreat.

Organisationally, this paper is divided into three sections, including the introduction. Section two discusses the workings of Section 131 in the light of similar provisions in more advanced jurisdictions and also the economic philosophy behind it, while section three offers some insights into possible options open to an investor (or company) that is confronted with this provision.

It must be emphasised that this paper is not intended to replace legal advice. Clients and readers are, therefore, advised to seek legal assistance whenever they are confronted with issues bordering on Section 131 ISA.

SECTION 131 ISA 2007: A minefield for the unwary investor

2.1 Section 131 provides as follows:

Where any person:

- acquires shares, whether by series of transactions over a period of time or not, which (taken together with shares held or acquired by persons acting in concert with him) carry 30 per cent or more (or any lower or higher threshold as may be prescribed by the commission from time to time) of the voting rights of a company; or

- together with persons acting in concert with him, holds not less than 30 per cent but not more than 50 per cent (or a lower or higher threshold as may be prescribed by the commission from time to time) of the voting rights and such person or any person acting in concert with him, acquires additional shares which increase his percentage of the voting rights, such person shall make a take-over offer to the holder of any class of equity share capital in which such person or any person acting in concert with him holds shares.

To appreciate fully the import of the above provision, one must understand its correlation with Rules 109A(ii) and 111(a) Securities and Exchange Commission (SEC) Rules made pursuant to ISA. In fact, in the only case so far where SEC has applied Section 131 ISA 2007, it did so in conjunction with Rules 109A(ii) and 111(a). Rule 109A (titled Rules relating to securities ownership) provides as follows:

- Every registrar shall file with the commission information on beneficial owners of 5 per cent or more of the company's shares.

- Any subsequent transaction by holder in (i) above shall also be filed with the commission...

Rule 111 (titled filing of notice by directors and other insiders upon sale or purchase of their shares in the company) provides in clause (a) as follows:

- "Directors and other insiders of public companies shall notify the commission of the sale of their shares in the company or any purchase of shares in the company not later than 48 hours after such activity".

The above provisions are quite clear. On the strength of the express provisions of the above rules under reference, if an investor having first acquired shares making up, say 26.5 per cent, in the share capital of a company, subsequently acquired additional shares directly or indirectly (through a nominee or similar arrangement), this immediately triggers the obligation to notify SEC under Rule 109A(ii).

On this basis, it should be noted that the base acquisition of 26.5 per cent is caught by the 5 per cent beneficial ownership test prescribed by Rule 109A(i). Any additional acquisition over the initial base investment ought to be notified to SEC by virtue of Rule 109A(ii).

In the same vein, if through the investment the investor in question commands management position and/or influence in the company, by definition he or she falls within "directors and other insiders" required by Rule 111(a) to notify the commission within 48 hours of any subsequent dealings in a company's securities by way of sale or purchase. Where that is not done, this would be in clear breach of the above provision, which SEC is well within its mandate as a regulator of the capital market to deal with.

While Rules 109A and 111 might have existed during the currency of ISA 1999, our observation was that though existing in the books, for the most part, they seemed to be hardly complied with by investors and corporate entities. This lack of compliance appeared to have been endorsed by SEC through its passivity.

However, recent events show that through enforcement of the new Section 131 in ISA 2007, SEC appeared to have awoken from its slumber and has begun to shoot with the arrows of Rules 109A and 111 in its quiver. Because lack of compliance could result in severe administrative financial penalties from SEC (as we have witnessed in some transactions), it is important that all investors and corporations take note and be wary.

On section 131, as stated above, the section is one of the innovations introduced in ISA 2007. Section 131 enacting what is called "mandatory offer provisions" obliges a person who either acquired up to 30 per cent or more of the voting rights of a company alone or in concert with others to make a mandatory offer to buy the shares of other shareholders in the class of shares that he has bought the 30 per cent or more shares.

In the same token, if a person alone or in concert with others already has up to 30 per cent but not more than 50 per cent of the voting rights, but subsequently acquires additional shares that would increase his voting rights, he is obliged to make a mandatory offer to buy the shares of other shareholders of the same class of equity where he made additional investment.

But there are a number of pertinent questions which make an understanding of the essence and working of mandatory take-over provisions such as in section 131 very compelling, including: what if the investor does not have the means to finance the bid for the rest of the shares of the company? If he had 29 per cent previously and could only finance additional two per cent shares, how does he discharge the obligation, as imposed by section 131, of acquiring the rest of the 69 per cent share capital of the company. If he has or could organise the finances, what if he lacks the desire or motivation (for whatever reasons) of acquiring the rest of the share capital of the company and the complications it might engender to the investor?

The purpose of Section 131 ISA 2007 is to give other shareholders an opportunity to exit a company in the event of change of control presumed to occur upon acquisition of set threshold of between 30 per cent and 50 per cent of shareholding of a quoted company by any person acting alone or in concert. Provisions similar to Section 131 ISA 2007 can be found in a number of jurisdictions with advanced securities laws.

In South Africa, it is provided for under Section 440 Companies Act 1973 and the Securities Regulation Code on Take-overs and Mergers (Code) made by the Securities Regulation Panel (SRP). Section 440 of the South African Companies Act 1973 prohibits any person from entering into an affected transaction except in accordance with the Code, unless the SRP exempts such person. The SRP also has a general discretion to authorise, subject to such terms and conditions as it may prescribe, non-compliance with or departure from any requirement of the Code, and to excuse or exonerate any party from failure to comply with any such requirement. An affected transaction is any transaction (including a transaction which forms part of a series of transactions) or scheme, whatever form it may take, which taking into account any securities held before such transaction vest control of any company (excluding a close corporation) in a person (or persons acting in concert) in whom control did not vest prior to the transaction.

For the purposes of the SRP Code, 'control' means, broadly speaking, a holding of securities entitling the holder to exercise 35 per cent or more of the voting rights in general meeting, notwithstanding that such entitlement does not involve the defacto control of that company. By Rule 8.1 (titled mandatory offer) of the Code, a person (or persons) who holds not less than 35 per cent but not more than 50 per cent of the voting rights in a company is prohibited from acquiring, in any one year, securities that carry more than five per cent of the voting rights in such company without making a similar offer to other shareholders.

The SRP Code is largely based on the City Code on Take-overs and Mergers issued by the London Panel on Take-overs and Mergers (Panel). Incidentally, Section 131 ISA 2007 appears to be on all fours with Rule 9 ("The mandatory offer and its terms") of the London City Code. Rule 9.1 provides that except with the consent of the panel, when:

- any person acquires, whether by a series of transactions over a period of time or not, shares which (taken together with shares held or acquired by persons acting in concert with him) carry 30 per cent or more of the voting rights of a company; or

- any person who, together with persons acting in concert with him, holds not less than 30 per cent but not more than 50 per cent of the voting rights and such person, or any person acting in concert with him, acquires additional shares which increase his percentage of the voting rights. Such person shall extend offers .... to the holders of any class of equity share capital whether voting or non-voting and also to the holders of any class of voting non-equity share capital in which such person or persons acting in concert with him hold shares...

The underlying principle behind the London City Code and all legislation modelled on it (example the South African SRP Code and Section 131 ISA 2007) is to ensure fair and equal treatment of all holders of relevant securities in relation to affected transactions.

As a complement to this overriding principle of equal treatment, there is also the principle that all holders of securities must be given the same full and adequate information in matters which affect their company and should equally profit from that information.

There are a number of reasons driving all mandatory bid provisions (Rule 8.1 South African Code, Rule 9.1 London City Code, Section 131 ISA 2007).

First, when a party acquires control of a company through the acquisition of substantial shareholding, there is usually a premium, which the buyer pays (the control premium) to the seller. Based on U.S. Court decisions, the control premium is rightly an asset of the company and not that of a particular shareholder.

By insisting on mandatory take-over offer to all shareholders on the terms in which the purchaser bought his substantial shares from an original first seller, that control premium which is an asset of the company is passed to all shareholders equally as against it being appropriated by one single shareholder.

Secondly, when shareholders invest in a company, they are assumed to have invested in the management of the company. Therefore, if a change occurs in that management due to acquisition of control by a new shareholder, then the shareholders should be given an opportunity to exit. The incoming substantial shareholder who has acquired control is obliged to make an offer to the other shareholders at the rate he or she gave to the exiting shareholder who sold shares to him or her.

To ensure the effectiveness of mandatory take-over provisions, the codes contain a principle that an offeror contemplating an acquisition that may give rise to an obligation to make a general offer to all other shareholders, must ensure that it can and will continue to be able to implement such an offer.

Because Section 131 ISA 2007 is a new provision in our jurisprudence, all concerned including SEC, are still struggling to come to terms with the underlying dynamics. There is, therefore, a tendency to make mistakes. Having stated that, where an unwary investor makes additional investment in a company which results in the protrusion of the investors shareholding in a company beyond the 30 per cent ceiling prescribed by Section 131 ISA (as in Rule 9.1 City Code) this could be construed as effectively giving him or her voting control vis-a-vis other shareholdings which are scattered into smaller holdings as to constitute any effective counter-voting power. (It is, however, noteworthy that other countries have exceptions or waivers for the mandatory take-over provision. The South African and the London City Code exceptions are discussed in greater details below).

It is possible to argue (and has indeed been argued in some transactions), that section 131 should not apply and thus a mandatory offer obligation created, where acquisitions which fall within the prohibited thresholds are made on the floor of an exchange as against when such acquisitions are made person-to-person, outside of an exchange.

In our view, such a proposition is hardly tenable. The key test for triggering mandatory offer provisions is acquisition of a shareholding beyond the prescribed threshold (called board control-seeking), it being irrelevant the method or avenue by which such acquisition is arrived at. The South African definition of an affected transaction under the Companies Act and the SRP Code makes it clear that an acquisition which meets the threshold shall be caught, whatever form it may take. The same appears to be the position under Rule 9.1 of the London City Code. Were the obligation to make mandatory bid to all shareholders be dependent on the method or avenue by which substantial acquisitions are carried out, parties may seek to structure share acquisition projects or transactions which ultimately achieve for them corporate control without the corresponding obligation under the rules to make mandatory general offer to all shareholders.

Having made the above observation, it may be noted that rather than prohibiting all acquisitions by an investor who falls within the threshold, the South African Code as noted above only prohibits such a person from acquiring, in any one year, securities that carry more than five per cent of the voting rights without making a similar offer to other shareholders.

The implication is that under the South African Code, if an investor who falls within the prohibited threshold acquires additional shares that are less than five per cent of voting rights of the company in a single year, he is not obliged to make a mandatory bid. The Nigerian Section 131 ISA 2007 on the other hand follows the London City Code in its blanket insistence that any additional acquisitions that increase the voting power of a substantial shareholder beyond the threshold must result in a general offer being made to all other shareholders.

However, it is to be noted that under the London City Code, the take-over panel has the right to grant dispensation from the mandatory offer obligation under Rule 9.1 in the following circumstances:

Vote of independent shareholders on the issue of new securities ("whitewash"): When the issue of new securities as consideration for an acquisition or a cash subscription would otherwise result in an obligation to make a general offer, the panel would subject to a few exceptions, normally waive the obligation if there is an independent vote at a shareholders' meeting approving the transaction.

- Enforcement of security for a loan: Where a shareholding in a company is charged as security for a loan and, as a result of enforcement, the lender would otherwise incur an obligation to make a general offer under the rule, the panel will normally waive the requirement provided that the security was not given at a time when the lender had reason to believe that enforcement was likely;

- Rescue operations: The panel will normally waive the obligation to make a general offer when the issue of shares to a rescuer is the only way in the view of directors and advisers by which a troubled company could be saved;

- Inadvertent mistake: If, due to an inadvertent mistake, a person incurs an obligation to make an offer under the rule, the panel will not normally require an offer if sufficient shares are sold within a limited period to persons unconnected with him or her;

- Shares carrying 50 per cent or more of the voting rights: The panel will consider waiving the requirement for a general offer under the rule where:

- holders of shares carrying 50 per cent or more of the voting rights state in writing that they would not accept such an offer; or

- shares carrying 50 per cent or more of the voting rights are already held by one other person.

Enfranchisement of non-voting shares: There is no requirement to make a general offer under the rule if a holder of non-voting shares becomes upon enfranchisement of those shares a holder of 30 per cent or more of the voting rights of a company, except where shares have been purchased at a time when the purchaser had reason to believe that enfranchisement would take place.

Conclusion and possible option

An investor or corporation confronted by challenges revolving around Section 131 ISA 2007 should seek specialist legal advice. From our experience of dealing with these issues, some options are available for exploration, including the following:

- Seek SEC waiver by way of special dispensation from section 131 obligations; this to be done even before the entry into a share acquisition transaction that would trigger mandatory take-over offer obligations.

- Where threshold is already exceeded unknowingly, seek SEC ratification of the transaction through waiver of mandatory take-over requirement upon approval of shareholders at a general meeting which approval could be proposed to SEC as condition for receiving its ratification.

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