

THE UNIVERSITY OF SYDNEY

FACULTY OF LAW

**EXAMINATION FOR THE GRADUATE DIPLOMA OF
CORPORATE SECURITIES AND FINANCE LAW; GRADUATE DIPLOMA IN
COMMERCIAL LAW; DOCTOR OF JURIDICAL STUDIES AND
MASTER OF LAWS**

EQUITY FINANCING

JUNE 2004

TIME ALLOWED: 2 HOURS

Plus

READING TIME: 15 MINUTES

- **CANDIDATES ARE REQUIRED TO ANSWER ANY THREE (3) QUESTIONS.**
- **ALL QUESTIONS ARE OF EQUAL VALUE.**
- **THIS IS AN 'OPEN BOOK' EXAMINATION.**
- **ANSWER EACH QUESTION IN A SEPARATE BOOK.**
 - **YOU MUST WRITE THE QUESTION NUMBER ON THE FRONT OF EACH BOOK.**
 - **THIS EXAMINATION BOOKLET MUST NOT LEAVE THE EXAM ROOM.**

Question 1:

Pebble Limited (**Pebble**) conducts a quarrying operation in all Australian mainland states and is an ASX listed public company. Pebble has on issue fully paid ordinary shares, partly paid ordinary shares and options (to subscribe for fully paid ordinary shares). The options have been issued to 5 executives under an executive share option plan. Some options have an exercise price of \$2.25 and others have an exercise price of \$2.90.

All holders of options also own fully paid ordinary shares. The managing director owns some of the options and all of the partly paid ordinary shares.

The fully paid ordinary shares are currently trading at \$3.08.

The largest shareholder in Pebble is Barney Limited (**Barney**) (another ASX listed quarrying company) which owns 22% of Pebble's fully paid ordinary shares. Given its large shareholding in Pebble, Barney is represented on the board of Pebble by one director, Wilma. Barney wishes to acquire 100% of Pebble.

You act for Barney.

1. Barney has asked you to advise on the advantages and disadvantages of using a scheme of arrangement rather than a takeover bid to effect the acquisition. During discussions with Barney, it becomes apparent that while Barney would prefer to have the backing of Pebble's board, it may wish to proceed even without the backing of Pebble's board. (15% of marks)
2. After receiving your advice, Barney decides to propose to Pebble a scheme(s) of arrangement under which:
 - all shares in Pebble other than those held by Barney are transferred to Barney in return for fully paid ordinary shares in Barney;
 - all options in Pebble are cancelled in return for a cash payment by Barney.

Barney has asked you to advise on the following issues:

- what member and creditor meetings are needed to approve the transaction? (20% of marks)
- how should the scheme(s) treat Pebble's shareholders who are resident in foreign jurisdictions that have laws preventing the issue of securities to those residents and what effect, if any, will this treatment have on the necessary meetings? (5% of marks)
- what information will need to be disclosed to Pebble shareholders and option holders in the relevant explanatory statement(s)? (15% of marks)
- how many votes will each option holder have at the member or creditor meetings? (10% of marks)

[Question 1 continues next page]

3. Soon after the transaction is proposed to Pebble, an article appears in a pre-eminent financial newspaper setting out details of the proposed transaction. In response, **Funds**, a larger investor in Pebble, issues a press release stating that it is vehemently opposed to the transaction and proposes to take all steps possible in order to prevent it occurring or at least to force it to be undertaken by way of a Chapter 6 takeover bid (which Funds believes is likely to yield a higher price).

Barney asks for your advice on whether Funds can force the transaction to be undertaken by way of takeover bid, including what steps could Funds take to try to achieve its objectives? Is ASIC likely to support Funds' objectives? (20% of marks)

4. Pebble is concerned that environmental activists seeking to limit the hours of operation (from 24 hours a day to 8 hours a day) at Barney's two most profitable quarries may be gaining the support of the local councils. Can Pebble include a clause in the scheme giving Pebble directors to change the terms of the scheme if the hours of operation of Barney's quarries are reduced? What would be the impact on court approval if the quarries were shut after shareholders vote on the transaction but before court approval? (15% of marks)

[Examination continues next page]

Question 2:

Reggie River and her husband Rusty (both software engineers) are establishing an investors' portal, *www.hotstocks4u.com.au*. The Rivers want to differentiate their site from the countless others through a number of novel features. The centrepiece is a program called the "Stock Clairvoyant" which generates predictions about the performance of shares. The Stock Clairvoyant requires people to enter their star sign, email address, income bracket and the name of a company listed anywhere in the world. A person may also choose to enter their mobile phone number. The Stock Clairvoyant then produces a simple message such as "better dump before the slump". Rusty tells you that the program which drives the Stock Clairvoyant looks at the closing price of the shares for the particular listed company for the previous 5 days and nothing more, and has a limited number of response messages. A graph of the 5-day history is shown to users of the Stock Clairvoyant at the bottom of the screen. Rusty has come up with a simple disclaimer for use in connection with the Stock Clairvoyant: "The Stock Clairvoyant is for fun; it is no substitute for proper independent investment advice".

In addition, the website will contain other interesting features such as "Investor's Itinerary" - a fortnightly overview of market activity which Reggie will compile with the help of newspapers, investor bulletins and her own internet research. Excerpts from Investor's Itinerary will be available for free, however access to the full text of each article will be by way of subscription (a \$30 once-off fee to become a registered reader). This is the only service for which the Rivers will charge users.

In time, the Rivers also plan to create a chat room for users of the site to discuss securities trading. The Rivers want to have a "share-seeking" notice board where people who are interested in buying or selling particular shares can post notices advertising this fact. The chat room and the noticeboard will not be on *hotstocks4u* but on another site, *www.findashare.com*, to which there will be a prominent link from *hotstocks4u*. The *findashare* website will be maintained by the Rivers' friends Noel and Liam Carpenter in Zaire but a web search using the terms "ASX", "Australian securities" or "Australian stocks" will identify the site.

The Rivers' main source of income from *hotstocks4u* will be commissions from companies whose stocks are given favourable predictions by the Stock Clairvoyant and companies whose stocks are directly marketed via *hotstocks4u*. Cutting Edge Inc., an American listed company, has approached the Rivers with a plan to issue its securities exclusively via *hotstocks4u*. Cutting Edge is planning to issue shares and its Australian subsidiary, Cutting Edge Jnr Limited, will issue units in the Cutting Edge Modem Trust (an Australian registered managed investment scheme). Cutting Edge has provided the Rivers with a CD-ROM with an electronic prospectus relating to both issues. The electronic prospectus contains hyperlinks to Cutting Edge's website and a sound-byte of a speech given by the Cutting Edge President. Cutting Edge has told the Rivers to prepare a suitable application form.

[Question 2 continues next page]

Cutting Edge has been pressuring the Rivers to start promoting both issues as soon as the website is established, even though the shares will not be issued until early next year and the units 6 months after that. Rusty has suggested using pop-up advertising windows on the website as a way to advertise the offer. Rusty has also suggested that an email promoting the offer could be sent to the email addresses of the customers who use the Stock Clairvoyant and that SMS messages could be sent to customers who have provided their mobile phone numbers.

The Rivers seek your advice on the following matters.

- a) Will they need any form of licence to run *www.hotstocks4u.com.au*? (50% of total marks)
- b) What should they do to ensure that they comply with Australian law in performing their role in relation to the issue of securities by Cutting Edge and Cutting Edge Jnr Limited? (30% of total marks)
- c) What are the risks to the Rivers with respect to the arrangements for operating *www.findashare.com* and how can these risks be minimised? (10% of total marks)
- d) Will Rusty's proposed advertising strategies contravene Australian law? (10% of total marks)

[Examination continues next page]

Question 3:

Your client Redco agrees to take a 40% stake in an established enterprise, which is both producing ore from an existing mining site and actively exploring for new resources. A final decision has yet to be reached as to the structure of the venture and it could be re-organised depending on other factors such as tax with which you are not concerned.

A letter of intent or heads of agreement is soon to be signed by your client with Blueco which holds a 50% stake and Greenco which has a 10% stake and which is an affiliate of Blueco.

Redco seeks your advice on how to safeguard its position.

Answer both of the following questions:

1. Discuss the types of provisions which you would advise your client, Redco, ought to seek to be included in the agreements between the three parties to afford Redco the main protections, assuming
 - a) a corporate vehicle in which they are the only shareholders
 - b) an unincorporated venture and a contractual arrangement between them
2. For each type of structure describe the likely or possible fallback remedies available to Redco at law in the event of squeeze-out measures being adopted by the other parties, assuming, and on the basis, that Redco fails to secure the protective provisions you have recommended.

Make your assumptions as to the factual position and any further information you would need.

Question 4:

Kevin Careful is the auditor of Goforward Limited (“the Company”), a public company listed on the Australian Stock Exchange. During the course of his audit work for the financial year ending 30 June 2003 he comes upon, or is aware of, the following information.

The Company has been listed for ten years and has paid up capital of \$40 million. Its primary business is in software development and internet marketing. It has valuable real estate, now worth \$45 million, which was bought for \$5 million at the inception of the business, just prior to listing. Its head office and factory occupy one part of the land (worth \$15m); it leases shops on the other part of the land (worth \$30m). The directors have revalued the land to \$45 million for the balance sheet.

As at 30 June 2003 the Company owned certain media stocks listed on the ASX and Nasdaq at prices giving a value of \$15 million. Now, in August 2003, when Mr Careful is finalising his audit work, they are valued at \$7,500,000 on those exchanges. The directors have not charged the profit and loss account with the \$7,500,000 reduction.

During the year 2002/2003 the company invested heavily (\$5 million) in new computer hardware, largely replacing that purchased just prior to listing. In the accounts the directors have depreciated this on a straight line basis over 10 years.

In 2001 the Company purchased other internet marketing software for \$2m. The directors have depreciated this over 10 years on a straight line basis. Since January 2003 the techniques of internet marketing have changed so drastically as to make the this software all but useless.

The Company has employed a young futures trader to whom the board has given strict trading limits. Two of the non-executive board members have long experience in futures trading and derivatives. Whilst all middle management have doctorates in computing and engineering, none has any financial market, futures or derivatives training. The trader handles both trading and “back office” tasks. The directors decided not to hire separate “back office” staff in order to keep costs to a minimum.

The directors have revalued up other shares held as investments by \$1 million, but did not revalue (up or down) other shares held by the company.

The statement of financial performance (profit and loss) showed trading profits of \$10 million for the year 2002/2003. In 2000/2001 and 2001/2002 trading losses were incurred in the sums of \$5 million and \$12 million respectively. The directors wish to pay such dividend as they lawfully can.

How should Mr Careful advise and what should Mr Careful say, if anything, to the Company (and to whom in the company) or otherwise do about these matters? If you do not think he need say, or do anything about a matter, explain why. If you think that he should say or do something explain why he should say something or otherwise act.

[Examination continues next page]

Question 5:

You are consulted by an Australian Credit Union ('ACU') who has heard about securitisation.

It has heard that there are a number of reasons for securitisation and a number of problems with it.

The main reason ACU may want to securitise the residential mortgage loans (also referred to below as the "assets") it owns is to get regulatory capital relief. It has been told that to get regulatory capital relief the sale of the residential mortgage loans must be structured as a "clean sale" or a "true sale". It is not too sure what this means and where this requirement comes from, and has no idea how it may be achieved.

ACU is an ADI, and is regulated by APRA.

Please advise ACU on the following questions:

- (a) what is regulatory capital relief?
- (b) where does the requirement for a "clean sale" of assets come from if an ADI wants to get regulatory capital relief?
- (c) would the following "enhancements" stop a sale of the assets being a "clean sale" for regulatory capital purposes:
 - (i) if ACU provided subordinated loans to the purchaser of the assets (ie the securitisation vehicle);
 - (ii) if ACU guaranteed the financial obligations of the purchaser of the assets;
 - (iii) if ACU entered into a credit default swap with the purchaser so that if there are any losses on the assets, ACU has to pay an amount equal to those losses to the purchaser under the swap;
 - (iv) if ACU pays the insurance premium for mortgage insurance on the residential mortgage loans that are sold to the purchaser.
- (d) by what lawful means may ACU securitise (eg sell) some of its residential mortgage loans under conventional Australian mortgage securitisation structures to achieve a clean sale?
- (e) what Australian cases could be drawn on to support the argument that an equitable assignment of residential mortgage loans by ACU would be treated as a clean sale under Australian law if ACU retains legal title in the assets, retains day to day control over the assets as the servicer of the assets, in practice is the only person who ever collects or enforces the assets, and has a call option to repurchase the assets in certain circumstances?
- (f) in what circumstances could a liquidator of ACU challenge the purported sale of the assets?

Your advice should include a consideration of APS 120. It should not include anything on the new securitisation rules under Basel 2.

Answers can be brief but must be reasoned or explained.

[End of Examination]