In the matter of Lachlan Farming Ltd
[2004] ATP 31

Catchwords:

rights issue, underwriting, genuinely accessible, delay, disclosure, allocation discretion, shortfall facility

Corporations Act 2001 (Cth) sections 602, 606, 611 item 10, 657C

These are the Panel's reasons for declining to commence proceedings in an application concerning the affairs of Lachlan Farming Ltd.

SUMMARY

1. These reasons relate to an application (**Application**) to the Takeovers Panel (**Panel**) from Lenvat Pty Ltd (**Lenvat**) under section 657C of the *Corporations Act 2001* (Cth) (**Act**) dated 22 December 2004 in relation to the affairs of Lachlan Farming Ltd (**LFL**).

2. On 27 December 2004 the Panel declined to commence proceedings in response to the Application, after receiving initial submissions from Lenvat addressing a number of concerns the Panel raised over issues relating to the course of events leading up to Lenvat making its application.

3. Lenvat alleged that unacceptable circumstances existed in relation to control of LFL, caused by the 1 for 1.19 rights issue (**Rights Issue**) currently being conducted by LFL, the terms of which were set out in a prospectus dated 17 September 2004 (**Rights Issue Prospectus**).

4. The Rights Issue of up to 18 million shares is underwritten as to the first 14 million shares by Rural Funds Management Limited (**RFM**) as responsible entity of the RFM Australian Cotton Fund (**ACF**). RFM also provides management services to LFL. Under the terms of the Rights Issue, LFL shareholders may apply to subscribe for any shares not taken up by other shareholders in the initial offer (**Shortfall Facility**). ACF could potentially increase its voting power (not including the voting power of any associates of ACF) from 1.97% to 46.7% as a consequence of the Rights Issue[1].

5. The Panel accepted a range of Lenvat's submissions that the information in the Rights Issue Prospectus could have been clearer and more accurate in terms of presentation, factual accuracy and perspective. However, the Panel did not think that the imperfections of the Rights Issue Prospectus, or of the underlying structure of the Rights Issue, were such that the Rights Issue was not genuinely accessible to LFL shareholders or that LFL shareholders were likely to have been materially misled by the deficiencies in the Rights Issue Prospectus.

6. The Panel was influenced by evidence that a director of LFL who is also a director of, and controls, Lenvat (**Mr T Allen**), disagreed with various issues in relation to the size and structure of the Rights Issue, but that neither he nor Lenvat advised the

[1] See paragraph 23 as to the voting power of RFM and ACF's associates.

Panel of any other action that he or Lenvat had taken in the three months since Mr Allen stated he had voted against various board resolutions relating to those aspects of the Rights Issue.

THE PANEL & PROCESS

7. The President of the Panel appointed Simon Mordant (sitting President), Karen Wood (sitting Deputy President) and Robyn Pak-Poy as the sitting Panel.

8. Lenvat, LFL and RFM provided notices of appearance. To the extent required, the Panel adopted the Panel's published procedural rules, and consented to the parties being legally represented by their commercial lawyers.

APPLICATION

9. Lenvat sought a declaration of unacceptable circumstances in relation to the affairs of LFL.

Orders sought by the Applicant:

10. Lenvat sought:

    (a) an interim order that LFL be prevented from closing the Rights Issue, or allotting any shares under the Rights Issue, prior to 10 January 2005;

    (b) orders that:

        (i) LFL obtain shareholder approval of the Rights Issue and ACF's underwriting of the Rights Issue having regard to Chapter 2E of the Act;

        (ii) the Shortfall Facility under the Rights Issue be modified:

            A. so that ACF, RFM and their respective associates do not participate in the Shortfall Facility until all other LFL shareholders eligible to participate in the Rights Issue have had their applications to participate in the Shortfall Facility satisfied in full;

            B. the inclusion of a clear explanation as to how shares applied for under the Shortfall Facility are to be allocated to LFL shareholders in the event more shares are applied for than are available and the removal of the notion that this allocation process is to be conducted in the unfettered discretion of the directors of LFL; and

            C. that the closing date under the Prospectus be extended to 7 February 2005 to allow LFL shareholders sufficient time to consider this modification; and

        (iii) such further orders as the Takeovers Panel considers appropriate.

BACKGROUND

11. LFL is an unlisted public company with approximately 221 shareholders.

12. LFL owns two cotton growing properties. These properties are managed by RFM on behalf of LFL under a farm management agreement.

Financial position of Lachlan

13. LFL has been affected by drought over a number of recent years, reducing its water entitlement from the Lachlan River and causing losses in the last three years. It advised its shareholders of an ongoing need for funds both last year and this year.

14. In July 2003, LFL offered a non underwritten rights issue to its shareholders at a price of $0.68 per share. However, the minimum subscription was not reached and the issue lapsed.

15. In October 2003, subsequent to the failed rights issue, LFL shareholders not associated with ACF approved ACF's subscription to, and conversion of, 6.4 million convertible notes to raise $4.3 million (**Convertible Notes**). The Convertible Notes were secured by a charge over LFL's assets. They were issued at $0.63 with a conversion/redemption date twelve months later. The Convertible Notes paid 0% coupon but were redeemable at $0.68, or were convertible if LFL met a number of performance criteria at the conversion/redemption date. If the Convertible Notes were not converted or redeemed, after the conversion/redemption date the coupon increased to BBSY+4%.

16. In October 2004, ACF loaned LFL a further $1 million on an unsecured basis (**Unsecured Loan**), for working capital until the proceeds of the current Rights Issue were received. The loan was at 9.9% p.a. increasing to 13.9% p.a. after the original date of the Rights Issue Prospectus (but ACF agreed not to enforce the higher rate when the repayment was extended to meet the extended Rights Issue closing date of 10 January 2005).

17. The Rights Issue is intended to repay the Convertible Notes, the Unsecured Loan and to provide $1.6 million working capital.

18. Although Lenvat agreed that LFL currently needs funds, it disagreed with the amount of funds required immediately. As noted below (at paragraph 31), Lenvat had offered to underwrite a smaller capital raising with a view to improved seasonal conditions allowing LFL to trade out of its current financial difficulties.

19. The Explanatory Memorandum to the Convertible Note issue in 2003 noted the Board's intention to undertake a rights issue in 2004 to raise further funds to meet its requirements given the then adverse seasonal conditions.

LFL Structure

20. LFL has five directors: three are also directors of RFM, one is a nominee of Lenvat and the other is independent of RFM, ACF and Lenvat.

21. Lenvat[2] is currently the largest registered shareholder in LFL, holding 4,589,596 ordinary shares in LFL (approximately 21.44% voting power).

22. The Rights Issue Prospectus discloses (in various places) that:

    (a) ACF currently holds 421,824 shares (1.97% voting power).

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[2]Twynam Investments Pty Ltd is the beneficial owner of all shares in LFL registered in the name of Lenvat. Mr John D and Mr John I Kahlbetzer are the controllers of Twynam.

(b) RFM in its own right holds 571,412 shares in LFL (2.67% voting power).

(c) The following directors of LFL, who are also directors and shareholders of RFM, have a relevant interest in the following shares in LFL:

David Bryant - 396,553 shares (1.85% voting power)

Anthony McAlary - 931,435 shares (4.35% voting power)

Maxwell Bourke - 450,400 shares (2.10% voting power).

23. The total voting power disclosed of RFM and these associates is therefore 12.94%[3].

Effect of the Rights Issue

24. The Rights Issue Prospectus clearly set out in a number of places the effect on ACF's individual voting power if ACF was required to take up all the 14 million shares under the underwriting agreement. The Rights Issue Prospectus also provided a table setting out various scenarios concerning the 4 million shares offered under the Rights Issue which were not underwritten by ACF. The maximum percentage of ACF's voting power was said to range from 37 % to 46% under different scenarios.

25. However, disappointingly, the Rights Issue Prospectus provided this information only in relation to ACF's direct holding. The Rights Issue Prospectus did not clearly disclose the aggregate voting power which ACF and its associates held before the Rights Issue or in any of the above scenarios[4].

Rights Issue

26. The Rights Issue is for the issue of up to 18,000,000 ordinary shares in LFL at 50 cents per share[5] seeking to raise up to $9,000,000. Each LFL shareholder is entitled to subscribe for one LFL share for every 1.19 LFL shares held (**Entitlement**) and under the Shortfall Facility any LFL shareholder may subscribe for more than their Entitlement and acquire those shares not taken up by other shareholders under their Entitlement. Where more shares are applied for under the Entitlement issue and the Shortfall Facility than are available, the Prospectus states that "any additional Shares will be allotted to each Shareholder in proportion to the number of Shares held at 5.00 pm on the date of this Prospectus" but that the **"Directors retain unfettered discretion on the allocation of Shares under this Offer"**.

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[3] If ACF had converted the 6.4 million Convertible Notes its individual voting power in the expanded capital of LFL prior to the Rights Issue would be 22.6%.

[4] The individual directors' shareholdings, and those of RFM, were disclosed in a separate section towards the back of the Rights Issue Prospectus.

[5] The net tangible asset backing of LFL is recorded in its accounts at $0.88 per share. The directors noted in the Rights Issue Prospectus that the $0.50 offer price was at an even greater discount to NTA than the previous rights issue in 2003, and that this was due to LFL's continuing poor financial position and uncertainty as to future seasonal conditions.

27. On 24 November 2004 the board of LFL resolved to extend the closing date of the offer under the Rights Issue Prospectus from 3 December 2004 to 10 January 2005.

28. The purpose of the Rights Issue was in part to repay monies loaned to LFL by ACF:

    (a) the Convertible Notes; and

    (b) the Unsecured Loan.

Underwriting

29. The Rights Issue is partially underwritten by RFM as responsible entity of ACF (**Underwriting Agreement**). The Rights Issue Prospectus states:

    > "If there is a shortfall in the number of subscriptions received under the Rights Issue from the target of 18,000,000 shares, the Underwriter is obliged to subscribe for this shortfall, up to 14,000,000 shares. If the shortfall is larger than 14,000,000 then the Underwriter may choose to also subscribe for any additional shares above this minimum underwritten level."

30. The Rights Issue Prospectus also states that LFL had approached "another major shareholder" to underwrite or co-underwrite the Rights Issue "however the shareholder was not willing to commit to such an arrangement".

31. Lenvat advised that it believed it was the other shareholder. However, Lenvat asserted that Mr Allen had orally made an offer on Lenvat's behalf to underwrite a rights issue to raise $2.5 million at an LFL board meeting in late July 2004, but that that offer was rejected by the LFL board. Lenvat also submitted that at that board meeting LFL had given Lenvat 7 days to make an alternative offer to the RFM underwriting, and that the board of LFL made no formal or other approaches to Lenvat. Lenvat submitted that it had not made a counter proposal while the financial status and ownership of LFL were unclear[6].

32. The Rights Issue Prospectus states that LFL considered seeking commercial underwriting for the Rights Issue but did not fully pursue the initial enquiries as LFL considered that it was unlikely to be successful given LFL's current financial position and the fact that its shares are not listed.

CONSIDERATION OF THE ISSUES

Initial request

33. On 24 December 2004, the Panel requested Lenvat to provide responses to a series of issues that concerned the Panel in its initial consideration of the Application. Those issues related to whether or not it was appropriate to commence proceedings. Lenvat provided its response on 27 December 2004.

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[6] Lenvat submitted that at that time LFL was actively seeking to sell both of its cotton growing properties and that Lenvat did not wish to make any financial commitment to LFL while both its properties were currently up for sale. Lenvat stated that it did not make an offer for either property.

Materials

34. The Panel considered the material before it in relation to the Application. That material included the application letter from Lenvat, Lenvat's letter of 27 December 2004 responding to the Panel's request of 24 December 2004, copies of correspondence between LFL and Lenvat leading up to the Application, the Rights Issue Prospectus[7] in relation to the Rights Issue, and other documents published by LFL. These included the notice of meeting, explanatory memorandum and independent expert's report for a convertible note issue from LFL in 2003 (**Convertible Notes**) and LFL's 2004 annual report.

Considerations

35. In light of the submissions and the above material, the Panel considered that it was not in the public interest to commence proceedings in response to the Application.

36. In coming to this decision, the Panel considered a number of issues including:

    (a) the Panel's reading of the Rights Issue Prospectus and its related documents, and the Application and its supporting documents;

    (b) the lack of support by LFL shareholders for the previous rights issue offered in 2003; and

    (c) the approval by LFL shareholders not associated with RFM of the issue and conversion of the Convertible Notes in November 2003 and the explanatory memorandum for the resolution to approve the issue of the Convertible Notes which stated that the Board's intention would be to have a future rights issue.

Rights Issue Prospectus

37. The Panel accepted a range of Lenvat's submissions that the information in the Rights Issue Prospectus could have been clearer and more accurate in terms of presentation, factual accuracy and perspective. However, the Panel did not think that the imperfections of the Rights Issue Prospectus, or of the underlying structure of the Rights Issue, were such that the Rights Issue was not genuinely accessible to LFL shareholders or that LFL shareholders were likely to have been materially mislead by the deficiencies in the Rights Issue Prospectus.

Actions of Mr Allen and Lenvat

38. In coming to its decision, the Panel also took into account the actions of Lenvat and the director of LFL who was also a director of, and controls, Lenvat (Mr Allen).

39. The Panel considered that it was significant that Lenvat advised that Mr Allen disagreed with, and voted against:

    (a) various issues in relation to the size and structure of the Rights Issue;

    (b) some aspects of the Underwriting Agreement; and

[7] Including the supplementary prospectus issued later.

(c) the retention by LFL directors of unfettered discretion over the allocation of shares under the Shortfall Facility;

but that neither he nor Lenvat advised the Panel of any other action that he or Lenvat had taken since Mr Allen voted against various resolutions relating to those aspects of the Rights Issue.

40. The Panel considered that this was particularly significant given that Mr Allen was one of only two directors of LFL who were independent of RFM and ACF. In such a position, the Panel considers that the onus was on Mr Allen to put his views to the board of LFL and to advise the shareholders of LFL of his and Lenvat's concerns (for example by requesting that his dissent, and reasons for it, be recorded in the minutes of the board of LFL and in the Rights Issue Prospectus).

41. The Panel considered it significant that Mr Allen and Lenvat had allowed over three months to elapse since the first of the issues with which Mr Allen had troubles had arisen before making the Application.

42. Lenvat submitted that the Panel should not consider the delay in bringing the Application as a reason for not commencing proceedings, as Lenvat had not taken professional advice as to challenging ACF potentially taking control of LFL until after a LFL board meeting on 24 November 2004 when Mr Allen was advised that no other LFL shareholders had applied for shares under the Rights Issue. The closing date of the Rights Issue was also then extended from 3 December 2004 to 10 January 2005.

Delay not absolutely conclusive

43. The Panel considers that the delay of Lenvat in bringing the Application, and Mr Allen and Lenvat's apparent inaction in relation to the Rights Issue after Mr Allen consented to the lodgement of the Rights Issue Prospectus, are material in its reasoning for not commencing proceedings. However, the Panel wishes to note that had the issues of concern raised by Lenvat in relation to the Rights Issue Prospectus and the structure of the Rights Issue been of sufficient seriousness, it would have commenced proceedings in relation to the Application, regardless of any delay by Lenvat or inaction by Mr Allen or Lenvat.

Convertible Notes

44. The Panel considered it material that the issue and conversion of the Convertible Notes was approved by the shareholders of LFL not associated with RFM. The Panel considered that this was evidence that the shareholders of LFL did not view a material shareholding (potentially affecting control of LFL) by RFM as being a materially adverse event.

45. The Panel noted that Lenvat advised that it had voted against the Convertible Note issue but that it had not advised LFL shareholders of this in the context of the Rights Issue Prospectus.

LFL directors' discretion over allocation of shares under the Rights Issue

46. In paragraph 5 above, the Panel notes some residual concerns regarding the structure of the Rights Issue. A specific concern of the Panel was the lack of certainty (both for the Panel and in the Rights Issue Prospectus) over which aspects of allocation the

directors are retaining discretion. The Panel considered that exercise of such a discretion in a manner which went against the principles set out in section 602 of the Act could well constitute unacceptable circumstances.

Intentions of ACF not to subscribe for additional shares over the underwritten 14 million

47. Lenvat complained about two aspects of ACF's subscription, or otherwise, of the 4 million shares under the Rights Issue which ACF was not obliged to subscribe for under the Underwriting Agreement. Lenvat submitted that:

  (a) ACF should not be allowed to subscribe for any of the 4 million shares because to do so, and subscribe for all 14 million shares required under the Underwriting Agreement, would cause ACF to contravene the 20% threshold in section 606; and

  (b) the Rights Issue Prospectus should contain a firm statement of ACF's intentions as to subscribing for any of the 4 million non-underwritten shares, rather than the Rights Issue Prospectus noting that ACF was entitled to subscribe for them if it wished.

48. In the material provided to the Panel in Lenvat's application, RFM had advised LFL that ACF would not be applying for any of the 4 million shares above the 14 million which it may be obliged to subscribe for under the Underwriting Agreement to the extent there was a shortfall. The Panel considered that this may be information that the board of LFL should give serious consideration to advising to all the shareholders of LFL prior to the rights issue closing.

Application of Item 10 of section 611

49. The Panel noted Lenvat's submissions in both the Application and its submissions of 27 December 2004 in relation to whether or not item 10 of section 611 would act to except an acquisition of excess shares by Lenvat, under the Shortfall Facility, from the prohibition in section 606.

50. The Panel noted Lenvat's request of the Panel to request ASIC to make submissions on the issue in the proceedings. Given that the Panel determined not to commence proceedings, it recommended that Lenvat raise the issue directly with ASIC for ASIC's advice as to its view of whether or not item 10 of section 611 would apply to an acquisition by Lenvat under the Shortfall Facility. Alternatively, Lenvat might consider making an application to ASIC to modify the provisions of the Act so that item 10 of section 611 definitely would apply to such an acquisition.

Conclusion

51. Given the information before it, the Panel declined to commence proceedings.

Simon Mordant
President of the Sitting Panel
Decision dated 27 December 2004
Reasons published 06 January 2005