The New South African Merger Procedure

By David Yuill

The South African M&A regulatory framework has undergone a significant change in recent times with the introduction of a new Companies Act on 1 May 2011. This is the first significant change to South African company law in the last three decades, with the previous Companies Act having been in place since 1973. The new Companies Act has introduced a number of new concepts into South African law, including, for the first time, a statutory merger procedure and shareholder appraisal rights. In this article, we focus on the statutory merger procedure and assess how it has fared in practice in the two years since the Companies Act came into effect.

South Africa has traditionally not provided for mergers or amalgamations in the true sense of the word, where one entity merges into another or two or more entities amalgamate into a new separate entity. Business combinations have generally been executed through the acquisition by one company of the shares or assets of another, through a scheme of arrangement, tender offer or sale of business. The adoption of a statutory merger procedure in the new Act therefore marks a significant departure from the old regime. It also brings South Africa into line with a number of major jurisdictions worldwide.

The merger procedure provided for in the Act is, on the face of it, both relatively straightforward and flexible, which is in keeping with the new Act’s intention of facilitating business combinations. Before considering how this has translated in practice, however, it is perhaps useful to set out a brief outline of the procedure itself.

Once the merger agreement is concluded, the merger must then be submitted to shareholders of each of the merging entities for approval (provided that the board must first be satisfied that each of the surviving merged entities will be able to satisfy the prescribed solvency and liquidity test). Approval of 75% of the voting rights exercised in respect of the resolution by disinterested shareholders (i.e. excluding shares held by the acquirer and its concert parties) is required. Furthermore, if shareholders holding 15% or more of the voting rights vote against the proposed merger, any dissenting shareholder may require the company to first seek court approval for the transaction before implementing. Even if the 15% threshold is not reached, any shareholder who has voted against the resolution may apply directly to the court for a review of the transaction. However, the bar for successful review is set high - the court may only set aside the resolution if it determines that the resolution is "manifestly unfair to any class of holders of the company’s securities" or if it determines that there was a significant and material procedural irregularity. Outside of these specific shareholder protections, a merger can also trigger appraisal rights for disgruntled shareholders, in terms of which they can, subject to certain requirements, require the company to buy their shares at fair value.

If no creditors object to the transaction, the parties may then proceed with the implementation of the merger. A notice of merger must be filed with the Companies Commission, and upon receipt of such notice the Commission will issue a registration certificate for each of the merging companies, and register each of the merging companies which is not intended to survive the transaction. The merger then takes place in accordance with the terms and conditions of the merger agreement. One of the key potential benefits of the new merger procedure is that in terms of the Act, all of the assets and liabilities of the merging companies are transferred, by operation of law, to the merged company or companies. This means that companies can avoid the costs and legal formalities normally required for the transfer of a business from one entity to another, as well as the length of time it takes to transfer things such as immovable and intangible property.

It is perhaps useful at this stage to briefly consider how the merger procedure compares to the other M&A mechanisms available in the South African context. Firstly, the sale of business - in terms of the Act, any disposal by a company of all or the greater part of its business requires a special resolution of shareholders. The shareholder approval requirements are the same as those for a merger, as is the court review process and appraisal rights procedure. Creditors would also need to be given constructive notice of the transaction in accordance with s 34 of the Insolvency Act. A sale of business is generally not a favoured method of implementing an M&A transaction involving the acquisition of an entire company or business, primarily because of the costs, legal formalities and time that is normally involved for transferring of a business from one entity to another. The merger procedure thus has, in theory, a significant advantage over a more conventional sale of business in that it provides for the automatic transfer of the property and obligations of the merging entities, as well as the dissolution by operation of law of the non-surviving entities without needing to go through liquidation proceedings. The sale of business may nevertheless be useful in those scenarios where an acquirer may want to cherry-pick certain assets and/or obligations of the target, as opposed to acquiring them all (as would happen in a merger). A sale of business also only requires the approval of the shareholders of the disposing company, as opposed to a merger where the approval of all merging entities’ shareholders are required.

A scheme of arrangement procedure is a flexible procedure involving an arrangement between a company and the holders of any class of its securities which may be used for a variety of different procedures, including, inter alia, a reorganisation of the share capital or a takeover. It has been the preferred method of implementing a friendly takeover in the South African context – typically the scheme of arrangement will be entered into between the acquirer, the target and the target shareholders, whereby the acquirer will acquire all or a substantial portion of the target’s shares.
In the past, one of the drawbacks of the procedure, was the requirement for judicial sanction of the scheme, which made it both costly and time-consuming. Under the new Act, however, the sanction of the courts is no longer required, except in the same limited circumstances as with a merger - instead, the company is required to provide an independent expert report on the transaction to its shareholders, who must then approve the scheme by special resolution in the same manner as for a merger.

Turning finally to the tender offer, the tender offer procedure provided for in the Act is substantially the same as the previous Act. Thus, inter alia, acquirers are required to make a mandatory offer for all the shares of the target once they have acquired a specified percentage of the target’s shares, an acquirer can squeeze out the minority if 90% or more of the shareholders not related to the acquirer accept its offer and the directors are not entitled, as in the UK, to take any actions that may frustrate the bid. The tender offer as a takeover procedure has certain benefits – it does not require the approval of the acquirer’s shareholders (which would be required for a merger, although not for a scheme), nor does it give rise to any appraisal rights on the part of the acquirer or target’s shareholders. It is typically the acquiring company’s method of choice in the context of hostile takeovers (which are becoming more prevalent in the South African context), given that the co-operation of the target’s board is not required in the way that it is for a merger or a scheme. However, shareholders can bring enormous pressure to bear on a target company board of directors to negotiate a sale by scheme or merger by the acquirer making a public “bear-hug” approach stating their willingness to pay a premium price. The downside of a tender offer, at least for the acquirer who is looking to squeeze out the minority, is that is a much higher threshold of shareholder acceptance (90%) is required for a squeeze-out than under a scheme or merger (75%).

On the face of it, the merger procedure would seem to offer certain significant advantages as a means of implementing transactions. It is a potentially very versatile and flexible procedure, which seems to offer a greater range of possible transactions than the other mechanisms discussed above. It also, by providing for the transfer of assets and liabilities by means of operation of law, can potentially make the administration involved in acquiring a business significantly simpler than the more laborious process involved in a straightforward sale of business.

However, to date there has, to our knowledge, been very little use of the merger procedure in the South African market, particularly in the public space. There are, in our view, a number of possible reasons for this. Firstly, this may be partially due to South African practitioners’ lack of familiarity with the procedure and the various possibilities that it offers. In the context of a friendly transaction, the preference still seems to be use the more familiar scheme of arrangement procedure, particularly given that its primary drawback under the old Act (the extensive involvement of the courts) is no longer required. Indeed, although it has the additional requirement of an independent expert report, the formalities required appear to be, generally speaking, less than those required for a merger procedure (given that no creditor notification is necessary, and only the approval of the target shareholders is required). Secondly, one of the key benefits of the merger procedure – that it simplifies the transfer of assets and liabilities – hasn’t, in our experience, seen much practice is that a conservative approach is partial because other areas of law are yet to catch up – thus, for example, intellectual property legislation has not yet been amended to provide for automatic transfer of intellectual property rights upon a merger, and the usual transfer processes have to be followed. Furthermore, due to uncertainty about the legal consequences of the procedure, what we have seen in practice is that a conservative approach is often followed (i.e. out of an abundance of caution, consents are still sought from counterparties for transfer of material contracts). Thirdly, the tax legislation has not yet been amended to specifically cater for mergers, and there is some uncertainty as to the tax consequences of a merger.

We would hope that certain of these issues (such as the tax uncertainty, and the fact that no provision has yet been made for automatic transfer of things such as immovable and intellectual property on a merger) will be addressed in the near future through appropriate legislative changes. If this is done, we would expect that the flexibility and versatility of the merger procedure should make it a potentially attractive option for South African deal-makers going forward, particularly once they become better acquainted with its possibilities.

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Recent M&A transactions that David has advised on include black economic empowerment transactions entered into by Merrill Lynch and Cisco Systems, Inc. involving the disposal of equity stakes in the listed parent companies to South African empowerment shareholders and the disposal by Boart Longyear of its mining capital equipment business to a private equity buyer. David was also part of the team advising Tongaat Hulett in its merger with Hulamin and the introduction of BEE partners into both Tongaat Hulett and Hulamin.

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1 - Please note that in writing this article we have drawn on a previous article written by ourselves and Trevor Norwitz - “A microscopic analysis of the new merger and amalgamation provision in the Companies Act 71 of 2008” in Modern Company Law for a Competitive South African Economy, Tshelop Mongalo (ed.), Acta Juridica, 2010, Juta.