

Traps for directors to avoid in M&A transactions

ACLA M&A series

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Sydney

Julie Hutton, Partner
James Halliday, Partner
Georgie Farrant, Partner



Outline

1

Managing
continuous
disclosure in M&A
transactions

2

Risks for
directors
(delegation /
reliance) and
counterparties

3

Due diligence and
directors' duties in
cross-border
transactions

Managing continuous disclosure in M&A transactions

Overview

1

Why talk about continuous disclosure?

- Key priority for ASIC
- Increase in shareholder class actions
- Difficult / fine judgment calls

2

Two perspectives

- When to disclose
- Accurate disclosure

“I find the continuous disclosure regime the most challenging regulation I need to deal with as a director”

Kevin McCann
Chairman, Origin Energy & Macquarie Group

When to disclose

1

**ASX
LR 3.1**

Once entity is aware of information concerning it that a reasonable person would expect to have a material effect on the price or value of its securities, it must immediately tell ASX that information

2

**ASX
LR 19.12**

Entity is aware of information if a director / executive officer has, or ought reasonably to have, come into possession of the information in the course of the performance of their duties as a director / executive officer

3

**ASX
LR 3.1A**

LR 3.1 does not apply while all of the following are satisfied:

1. a reasonable person would not expect the information to be disclosed
2. the information is confidential and ASX has not formed the view that it has ceased to be confidential
3. one or more of the following applies:
 - the information concerns an incomplete proposal or negotiation
 - the information comprises matters of supposition or is insufficiently definite to warrant disclosure

When to disclose (cont'd)

1

Trend towards earlier disclosure

- Avoid criticism and regulatory scrutiny
- Strategic objectives – solicit rival bidders

2

Rio Tinto example

- Rio Tinto and Alcan in merger discussions
- Alcan tells Rio Tinto it is preferred bidder
- Dow Jones Newswires reports deal imminent
- Rio Tinto goes into trading halt 72 minutes later
- ASIC hits Rio Tinto with \$100,000 fine

When to disclose (cont'd)

David Jones case study

What happened?	What could DJs have done better?	Recommendations
<ul style="list-style-type: none">▪ 1st approach 28 May - requests details but none provided▪ 2nd approach 28 June▪ Blogger posts details / alerts news services▪ Friday 29 June: DJs issues 2 announcements:<ul style="list-style-type: none">➢ 1st – little detail – sets market running➢ 2nd – greater clarity – share price comes back down▪ Monday 2 July: Bid withdrawn▪ EB Private Equity unmasked as “phantom bidder”	<ul style="list-style-type: none">▪ ASIC – Accurate leak:<ul style="list-style-type: none">➢ announce➢ go into trading halt▪ Trading halt:<ul style="list-style-type: none">➢ cautious / sensitive➢ valid justification▪ Announcement<ul style="list-style-type: none">➢ no choice but to disclose➢ but manner of disclosure criticised<ul style="list-style-type: none">- insufficient detail re bidder- too ambiguous about credibility of bid	<ul style="list-style-type: none">▪ Be prepared for a leak▪ If receive proposal / in merger discussions – prepare draft announcement / trading halt application▪ If rumour / speculation turns specific – have them ready to go▪ No leak:<ul style="list-style-type: none">➢ exercise caution before announcing speculative deal➢ Establish bona fides

Accurate disclosure

1

Consider strategic objectives

- **Legal obligations**
 - disclose material price sensitive information
 - ensure not misleading or deceptive
- **Communications strategy**
 - desire to sell good news story



2

James Hardie example

- **Announcement made very emphatic statements**
 - “fully funded”
 - “provided certainty”
- **Why?**
 - need to “sell” proposal to stakeholders – shareholders, financial markets, victims and government
 - have markets recognise / reward certainty and finality of separation
 - minimise reputational damage

Accurate disclosure (cont'd)

Fortescue case study

Facts	Issues
<ul style="list-style-type: none">Fortescue announces to market it has entered into “binding agreements” with Chinese companies to finance, build and transfer Pilbara Iron Ore and Infrastructure Project: mine, port and railwaySeeking to establish credibility in marketAFR asserts agreements not binding – agreement to negotiate onlyASIC brings proceedings against Fortescue and CEO Andrew ForrestHigh Court decision pending	<ul style="list-style-type: none">Misleading and deceptive conduct  <ul style="list-style-type: none">Breach of continuous disclosure obligations  <ul style="list-style-type: none">Breach of duty of care and diligence

Accurate disclosure (cont'd)

Fortescue case study (cont'd)

Misleading and deceptive conduct	Breach of continuous disclosure obligations	Breach of duty of care and diligence
<ul style="list-style-type: none"> ▪ Statement regarding legal effect of agreement: <ul style="list-style-type: none"> ➢ statement of opinion; or ➢ statement of fact? ▪ Held: Statement of fact ▪ If want to announce agreement that contemplates more formal agreement: <ul style="list-style-type: none"> ➢ seek advice on binding status ➢ make clear binding status is opinion only ➢ disclose full terms 	<ul style="list-style-type: none"> ▪ s674(2) Corporations Act: <ul style="list-style-type: none"> ➢ failure to disclose only; or ➢ misleading disclosures as well? ▪ Held: If misleading statement made, s674(2) requires it be corrected ▪ How can you disclose true position if don't know original statement is misleading? ▪ Consequences: <ul style="list-style-type: none"> ➢ civil penalty provision ➢ infringement notices 	<ul style="list-style-type: none"> ▪ Forrest's "knowing participation" meant he was involved in contraventions ▪ Breach of statutory duty of care and diligence: "back door" method to sheet home liability to directors ▪ Business judgement defence not available: <ul style="list-style-type: none"> ➢ decision not to disclose true effect of agreement not a business decision ➢ decision related to compliance with Corporations Act

Risks for directors and counterparties



Overview

1

Risks for directors

- Delegation of powers
- Reliance on others

2

Risks for
counterparties and
the Bell litigation

3

What lies ahead?

Case study

1

Background

- Jill is the chief financial officer of Hill Resources
- The board of Hill Resources believes it is being undervalued by the market, due to an underperforming business unit (Pale Water Enterprises)
- The board appoints an adviser which recommends the sale of Pale Water

2

Vendor DD

- The board asks Jill to produce a vendor due diligence report which includes normalised financials
- Jill commissions a large accounting firm, Jack & Associates, to prepare the report

3

Sale process

- Hill goes through an auction process and provides the report to bidders, then sells to a preferred bidder
- Unfortunately, it then turns out that the Jack & Associates report materially understated the value of Pale Water, due to arithmetical error
- As a result, Pale Water has been sold for a bargain

4

Consequences

- Neither Jill nor the board noticed the error
- Hill's investors are furious. Class action firms are circling. ASIC is investigating

Risks for directors

Directors and officers

1

Who is a director?

A director is:

- a person who is appointed as a director or an alternate
- another person who acts as a director
- a person in accordance with whose instructions and wishes the directors or the company are accustomed to act

2

Who is an officer?

An officer is:

- a director or secretary, or a person in accordance with whose instructions the directors are accustomed to act
- a person who makes decisions affecting the whole or a substantial part of the business, or who can affect significantly the corporation's financial standing

Delegation

1

Subject to the company's constitution, the directors of a company may delegate their powers to any of the following:

- a committee of directors
- a director
- an employee of the company
- any other person

2

A director remains responsible for the delegate's exercise of powers as if exercised by the directors, unless the director reasonably believed the delegate:

- would exercise powers in conformity
- the delegate was reliable and competent

Reliance on information

1

When is reliance permitted?

A director may rely upon information or advice, provided it is prepared by:

- another officer or committee within authority
- an employee whom the director reasonably believes is reliable and competent
- a professional adviser within expertise

2

When is reliance reasonable?

- Reliance is reasonable if the director does so in good faith and following an independent assessment
- Reliance is taken to be reasonable unless the contrary is proved

Vines v ASIC (2007 NSWCA)

Facts	Held
<ul style="list-style-type: none">▪ AMP announced a bid for GIO▪ GIO released a profit forecast which was allegedly overstated▪ The profit forecast included information signed off by the CFO (Vines) in the due diligence committee	<ul style="list-style-type: none">▪ Held:<ul style="list-style-type: none">➤ Vines was an officer of the company who had:<ul style="list-style-type: none">- failed to advise the DDC of the assumptions underlying the forecast- taken advice from another executive without further inquiry, even though warning signs existed

K-sea Transportation Partners (USA 2012)

Facts	Held
<ul style="list-style-type: none">▪ A publicly traded Delaware limited partnership agreed to be acquired by a bidder▪ Merger agreement provided that a separate payment would be made to the general partner to acquire certain partnership interests▪ Board submitted the transaction to a conflicts committee to determine the fairness of the payment▪ Committee relied upon an investment bank's fairness opinion	<ul style="list-style-type: none">▪ The reliance was reasonable▪ The bank was duly qualified to give the opinion

Risks for counterparties

Barnes v Addy (1873)

Facts

- Barnes appointed Addy as an executor of his will
- Addy appointed another executor
- Barnes' solicitors advised him not to appoint a sole executor
- The executor misapplied the estate moneys and became bankrupt

Held

- The solicitor was not liable. A third party is only liable for breach of a fiduciary obligation where:
 - the third party receives part of the trust property with knowledge of the breach (knowing receipt); or
 - the third party assists a trustee with knowledge of the trustee's dishonest and fraudulent design

Westpac v Bell Group Limited (WA 2012)

Facts

- The Bell Group was under financial stress
- It agreed to:
 - grant security over group assets to the banks
 - subordinate the intra-group indebtedness to the banks' claims
- The Bell companies were later placed into receivership and liquidation
- The receiver sold assets and paid the proceeds to the banks

First instance

- The liquidator alleged the banks had knowingly received the proceeds or knowingly assisted in a breach of directors' duties
- At first instance, Owen J ordered the banks to repay the proceeds to the liquidator
- On appeal, a key question was whether the directors had breached any fiduciary obligations to the companies

Westpac v Bell Group Limited (WACA)

Best interests

- The directors had looked only at the global interests of the group rather than taking into account the best interests of individual group companies (and creditors and shareholders)

Proper purpose

- The directors entered into the refinancing transactions in the interest of the banks and failed to act with a proper purpose

Conclusion

- Held that:
 - these obligations were fiduciary in nature
 - the banks had knowingly received the receivership proceeds and knowingly assisted in the breach of duty
- As a result, the transactions be set aside



Conclusions

1

Company officers

- **Company officers must:**
 - **inform themselves of the matter under discussion**
 - **actively question third party material**
 - **not rely blindly on employees or advisers**

2

Third parties

- **Third persons transacting with companies must:**
 - **not knowingly receive a benefit associated with a breach of duty by the seller's officers**
 - **not knowingly assist in a breach of duty by the seller's officers**

Questions and case
study answers

Due diligence and
directors' duties in
cross-border transactions



Risks in M&A

(E&Y 11th Global Fraud Survey)



The Ugly: eLandia acquisition of Latin Node

1

Facts

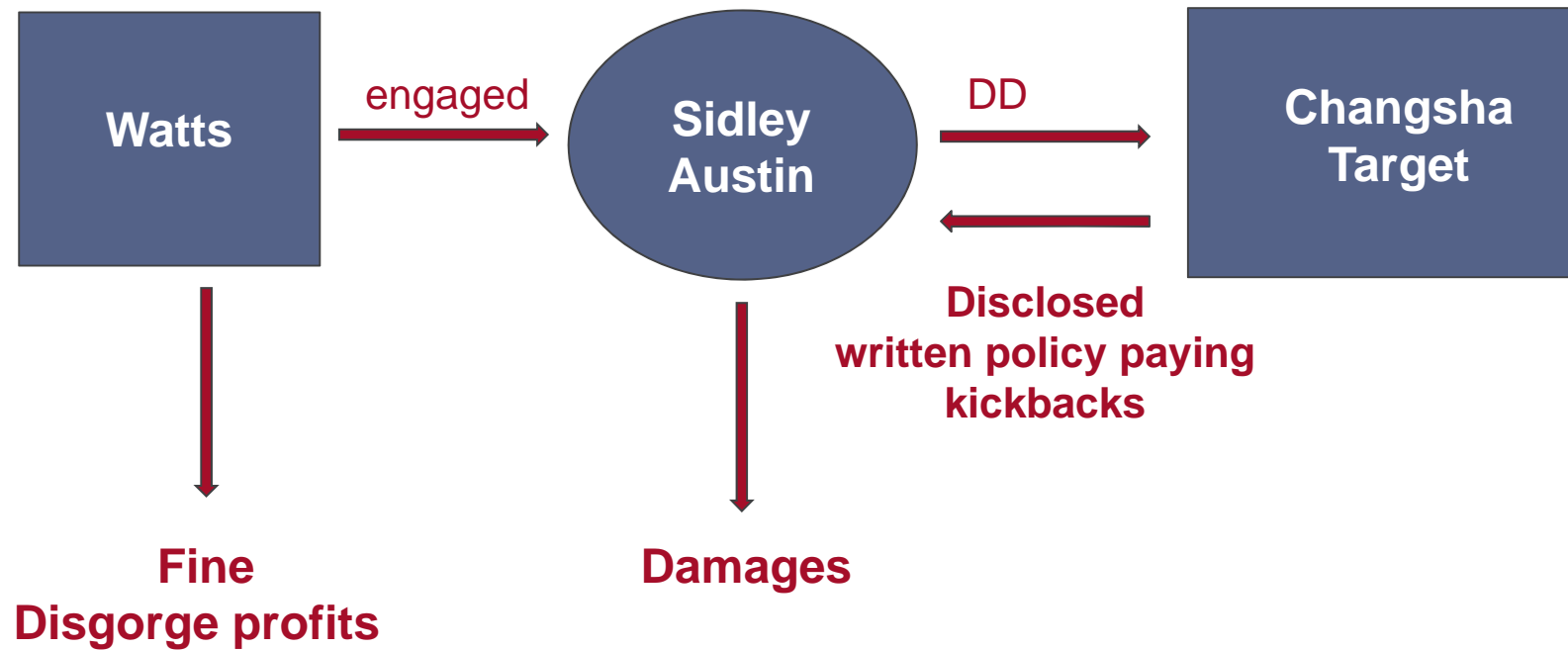
- Acquisition price \$22.3M
- Post closing due diligence uncovered \$2.25M in improper payments

2

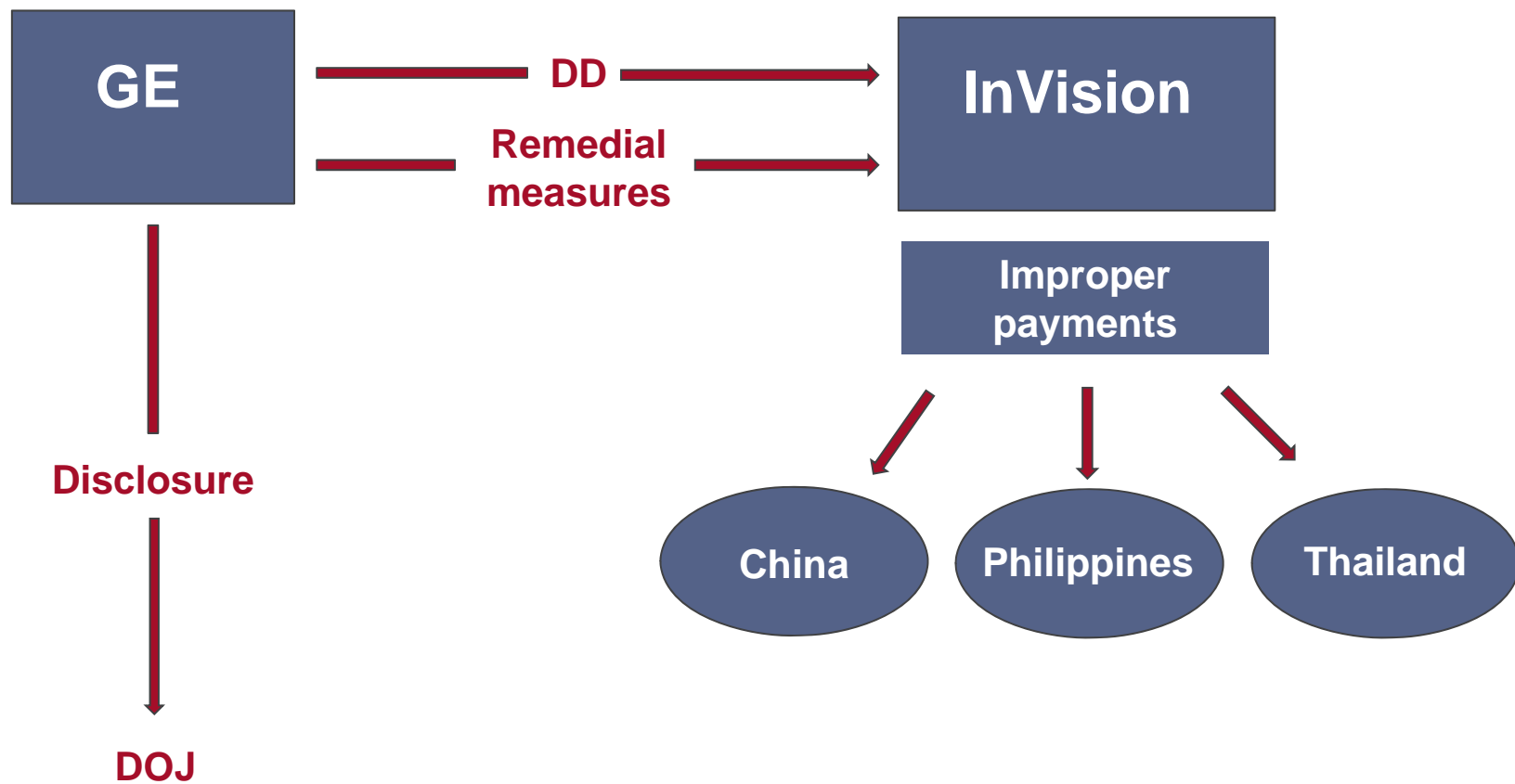
Consequences

- Fines
- Investigation costs
- Termination of senior management
- Loss of business
- Total \$18.2M
- Business closed down

The Bad: Watts Water Technologies



The Good: General Electric



Importance of DD: Risks

1

Fines

- Successor liability
- Continuing breaches
- Immediate breach of books and records offence

2

Damages claims

- Customers
- Competitors
- Shareholders

3

Reputation

- Share price
- Tender disclosures
- Government contacts

4

Director obligations

- Company fines
- Personal fines
- Disqualification

Relevance of board actions to corporate criminal liability

1

Board of directors intentionally, knowingly or recklessly carried out the relevant conduct, or expressly, tacitly or impliedly authorised or permitted the commission of the offence

2

High managerial agent of the body corporate intentionally, knowingly or recklessly engaged in the relevant conduct, or expressly, tacitly or impliedly authorised or permitted the commission of the offence

3

A corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance

4

Proving that the body corporate failed to create and maintain a corporate culture that required compliance

Directors' personal liability

1

**s 180 and
common
law/equity**

2

**AWB
ASIC v Vines**

3

**Greatest risk is
failure to undertake
risk assessment and
implement policies
and procedures post
acquisition**

DD stages: Determining appropriate scope

1

Ability to undertake effective corruption DD prior to acquisition depends on variety of factors

- **Public or private transaction/hostile takeover**
- **Buyer exclusivity**
- **Public auction/Bid element**
- **Respective bargaining positions of parties**
- **Time available**

2

If buyer decides to proceed without complete DD pre-signing

- **Pre-closing/post-signing DD and implementation planning critical**
- **Enabling buyer to achieve compliance with laws ASAP upon taking control of the entity**

Red Flags

1

Where

- Transparency International Corruption Perception Index
- Countries with high levels of enforcement

2

Who

- Government entities as customers
- State owned operations
- Reliance on permits/licences

3

What

- Industry risk – Transparency International Bribe Payers Index
- Competitive markets

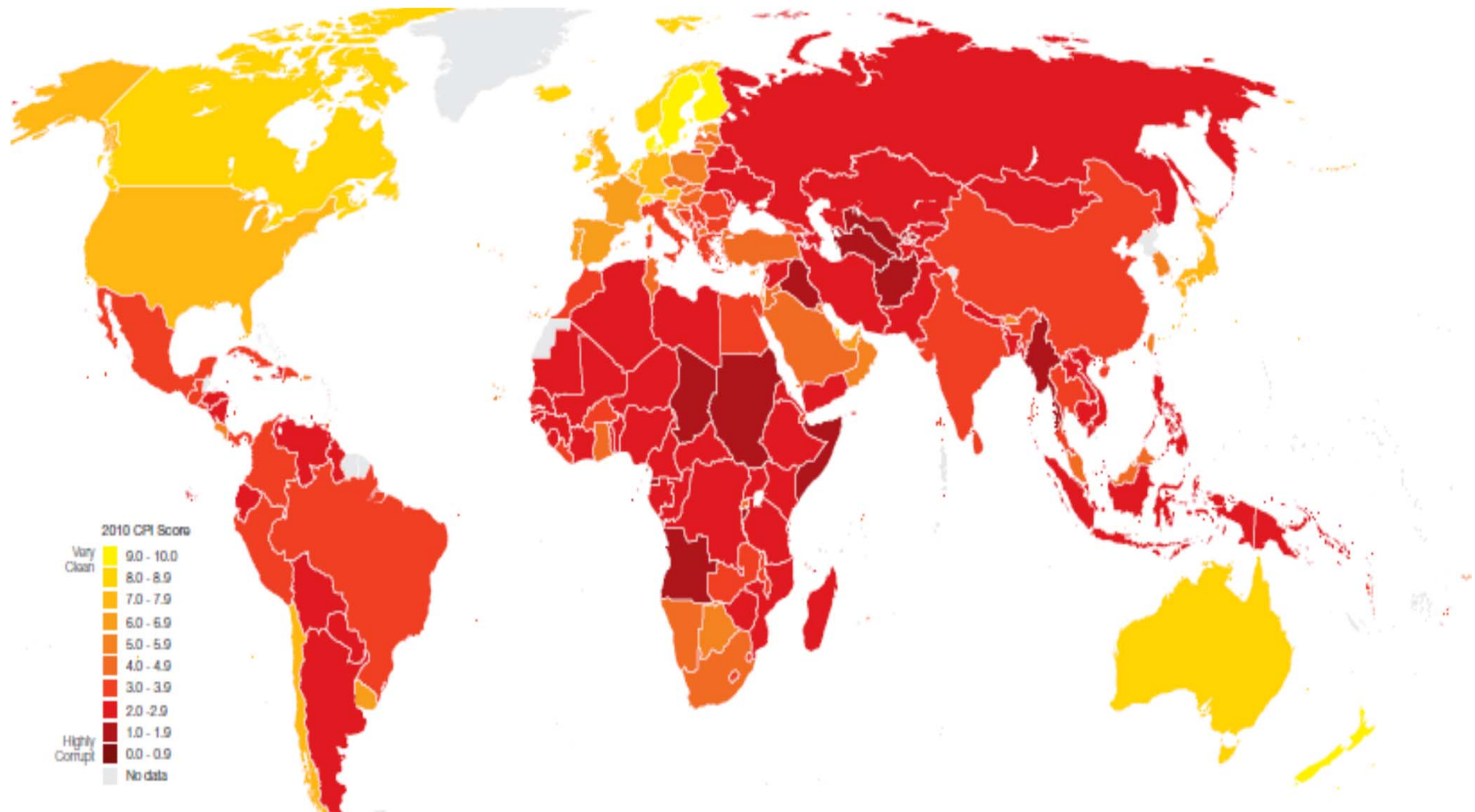
4

How

- Intermediary and agents
- Management/board awareness of risk
- Policies and procedures

A map of corruption

(Transparency International Corruption Perceptions Index)



Stages: when red flags appear?

1

Stages

- Q&A
- Review of documents
- Advice

2

Consider options available

- Proceed as planned
- Proceed but with a price adjustment
- Proceed but carve-out problematic assets
- Proceed with enhanced contractual protection - warranties, indemnities, conditions precedent, conditions subsequent at seller's cost
- Proceed with conditional agreement (pre-closing DD)
- Delay transaction and require an audit/healthcheck by independent body
- Proceed after regulatory consent
- Walk away from transaction

Stages: Post-Closing

1

Buyer should continue due diligence at integration

2

Risk assessment

3

Institute “clean-up” program to address identified concerns

4

Plan and implement roll-out, including:

- ongoing DD
- harmonisation of target’s programs and among intermediaries
- training of employees

5

Fulfil commitments made, if any, to the regulators

6

Warranty protection audit – identify all potential claims and notify seller before expiry of contractual limitation period

Contacts



Julie Hutton
Partner
+61 2 8922 5181
julie.hutton@bakermckenzie.com



James Halliday
Partner
+61 2 8922 5187
james.halliday@bakermckenzie.com



Georgie Farrant
Partner
+61 2 8922 5601
georgie.farrant@bakermckenzie.com