BEYOND ACCEPT OR REJECT: ARMING BOARDS IN RESPONDING TO ACTIVIST CONTROL SITUATIONS

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Legal Briefings

The recommendation of the Cardno directors is a timely reminder that boards are armed with the ability to differentiate their recommendation to cater for the interests and objectives of different shareholder groups.

However, target boards must not underestimate or underuse the power of their recommendation in negotiations with hostile bidders, even where they are pressured to engage through shareholder activism.

Directors' recommendations continue to serve as the most powerful tool available to boards in fending off unwanted or undervalued takeover offers. Securing a target board's recommendation should be used by boards discerningly as part of negotiations with a bidder, where it will, in almost all cases, command a premium.

By way of illustration of the importance of a target board recommendation, in FY15 (consistent with previous years) deals launched without target board support only had a success rate of 41% compared to 89% for deals launched with target board support.[1]

The recent recommendation made by the Cardno Limited directors (discussed below) is a timely reminder that target directors can be nuanced in their recommendation, differentiating it for groups of shareholders in recognition of their differing interests and objectives. However, although recommendations can continue to be effectively used as a bargaining tool, they must be instructive for shareholders that look to the board in the first instance to assess the merits of an offer.

The consideration of directors’ recommendations is particularly relevant in an environment of rising shareholder activism, which in Australia has largely been focused on control situations. Such activism has added a level of pressure on boards seeking to be resolute in their recommendations.

A DEFENDABLE RECOMMENDATION OR REASONS WHY NO RECOMMENDATION IS MADE

There is a statutory obligation on each target director to make a recommendation to shareholders to either accept or not accept a takeover bid or, alternatively, to explain why a recommendation has not been made in target statements.

In formulating a recommendation, the target directors will need to take account of various matters, such as:

- the likely benefits to the target group and its shareholders that may arise from accepting the offer, balancing both their long term and short term interests,
- the benefits of acceptance and whether they are outweighed by the risks,
- whether the conditions of the offer diminish the value of the consideration offered or introduce uncertainty about whether a firm sale of shares will be achieved,
- the independent expert’s assessment of the offer (bearing in mind that the directors are free to disagree with the expert, if they so choose), and
- whether an alternative transaction or maintaining the status quo is preferable to acceptance of the takeover bid.

The board will need to be able to justify its decision, which involves an implicit view on value. Target directors must balance their views on fundamental value against the right of shareholders to determine the outcome of change of control transactions. Target directors must also ensure they comply with their duty to act in good faith in the best interests of the corporation and for a proper purpose.The Board will need to be able to justify its decision, which involves an implicit view on value.

THE CARDNO BOARD RECOMMENDATION

On 14 September 2015, Crescent Capital, which held 19.6% of Cardno, announced that it intended to make a proportional off-market takeover bid to acquire one out of every two shares held by Cardno shareholders, other than Crescent, for $3.15 per share. The Cardno board advised shareholders to reject the Crescent offer.

In an activist move designed to procure the Board's support for the hostile bid, Crescent informed Cardno that it would be using its shareholding to vote against re-election of three of Cardno's directors and Cardno's remuneration report. Crescent was unsuccessful in undermining the re-election of the directors, but did secure a 'first strike' against Cardno for its remuneration report.

Soon after, Cardno received a revised offer from Crescent, comprising of a 9.5% increase in the cash offer and freeing the offer from all conditions. Cardno also agreed to certain changes in the board composition subject to Crescent obtaining at least 30% of the voting power in Cardno, including the resignation of two directors and the appointment of three new Crescent nominated directors and a new independent director.

In light of the improved offer, the Cardno directors changed their recommendation to:

"The Board therefore considers that shareholders with a short to medium term investment time horizon and lower risk tolerance might consider accepting the Increased Offer in the absence of a superior proposal.

However, shareholders seeking to realise the full underlying value of Cardno over time, who have the expectation of a longer term recovery in earnings, should equally consider rejecting Crescent's Increased Offer, recognising that this approach has higher risk, and requires a longer term investment horizon given Cardno's current circumstances."

In respect of the directors' intentions for their own shares, the Cardno directors went on to say:

"All current directors own Cardno shares and consider themselves longer term shareholders with a longer term investment horizon. None of the Directors currently intends to accepts the Crescent offer in respect of their shareholding but may review this position of Crescent obtains control of Cardno."

ARMING THE BOARD AND MAXIMISING UTILITY OF THE RECOMMENDATION

Certain media commentators have been very critical of the Cardno board's changed recommendation, some describing it as being 'gutless'. That view understates the challenges faced by the Cardno directors.

While it would appear that the Cardno directors do not believe the offer exceeds their view of fundamental value, they acknowledge that some shareholders may find the offer compelling. It should be noted that the Cardno board has secured an uplift in consideration as a result of the change in recommendation, while still maintaining some bargaining power by withholding the 'accept' recommendation.

The Cardno situation is certainly not the first time a differentiated recommendation has been adopted. Among the examples is this detailed recommendation adopted in Elph Pty Limited's bid for Engenco Limited in 2013, where the Board advised that:

"Shareholders with a medium to longer term investment horizon should Reject the Offer. In rejecting the Offer, Shareholders should be prepared to accept the risks and uncertainties that may be associated with retaining a shareholding in Engenco. The [Independent Board Committee] considers that rejecting the Offer is a higher risk option for Shareholders.

However, Shareholders who have a short term investment horizon may Consider Accepting the Offer (in the absence of a superior proposal). The Independent Expert is of the opinion that, subsequent to the conclusion of the Bid Offer, it is likely (at least in the short term) that Engenco Shares will trade at a discount to the Bid Offer price. Given the Company's recent trading performance and further cost reduction and business re-organisation initiatives that are required, the Independent Directors cannot be confident that the opportunity to realise a higher price in the foreseeable future or reasonable trading liquidity will be available. The [Independent Board Committee] considers that accepting the Offer represents a lower risk option for Shareholders."

Similarly, in 2010 the Aevum directors provided the following recommendation in response to Stockland's 2010 hostile takeover bid:

"On balance and after careful consideration of Stockland's Revised Offer and the factors discussed below, your Board unanimously recommends that Shareholders with a short to medium term investment horizon ACCEPT Stockland's Revised Offer in the absence of a superior proposal.

You should be aware that the decision to recommend acceptance was made after much deliberation and was at the margin. HOWEVER, if you are a Shareholder with a longer-term investment horizon with a focus on seeking to realise the full underlying value of Aevum and you want to participate in the significant opportunities presented by Aevum whilst accepting the inherent risks, you may CONSIDER REJECTING Stockland's Revised Offer."

COMMENTARY

A common theme in these differentiated recommendations is that they acknowledge the differing investment time horizons and risk tolerance of shareholders. Not all shareholders have the patience or tolerance to wait for the target to realise the board's view of fundamental value.

Target boards may be sympathetic to this view and reach a conclusion that, where an offer is finely balanced, differing shareholders should take differing positions in respect of the offer based on their objectives.

The emergence of shareholder activism adds an interesting overlay to board recommendations. Boards often feel under siege where a hostile bidder goes live with an unsolicited offer. 'Defending the fortress' can be made all the more challenging when coupled with activist shareholders agitating for engagement, such as that experienced by Cardno. Such activism (or its threat) may tempt boards to consider neutralising their recommendation, beyond the binary 'accept' or 'reject' recommendations.

However, it would be a disappointing development if a trend emerges in which target directors shy away from giving firm reject or accept recommendations, even where activist forces are at play.

Securing board recommendation must continue to serve as a powerful lever, one that should ordinarily command a premium. Target directors should be resolute where they believe an offer is not in the best interests of shareholders.

This article was written by Kam Jamshidi, Senior Associate, Melbourne.

END NOTES

1. Source: Herbert Smith Freehills, Australian Public M&A Report, 2015, Seventh Edition.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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