HERBERT SMITH FREEHILLS

DEAL PROTECTION IN THE SPOTLIGHT

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Legal Briefings – By **Adam Charles and James Paolucci**

The Takeovers Panel recently declined to make a declaration of unacceptable circumstances in relation to Pacific Energy Limited's handling of competing bids.

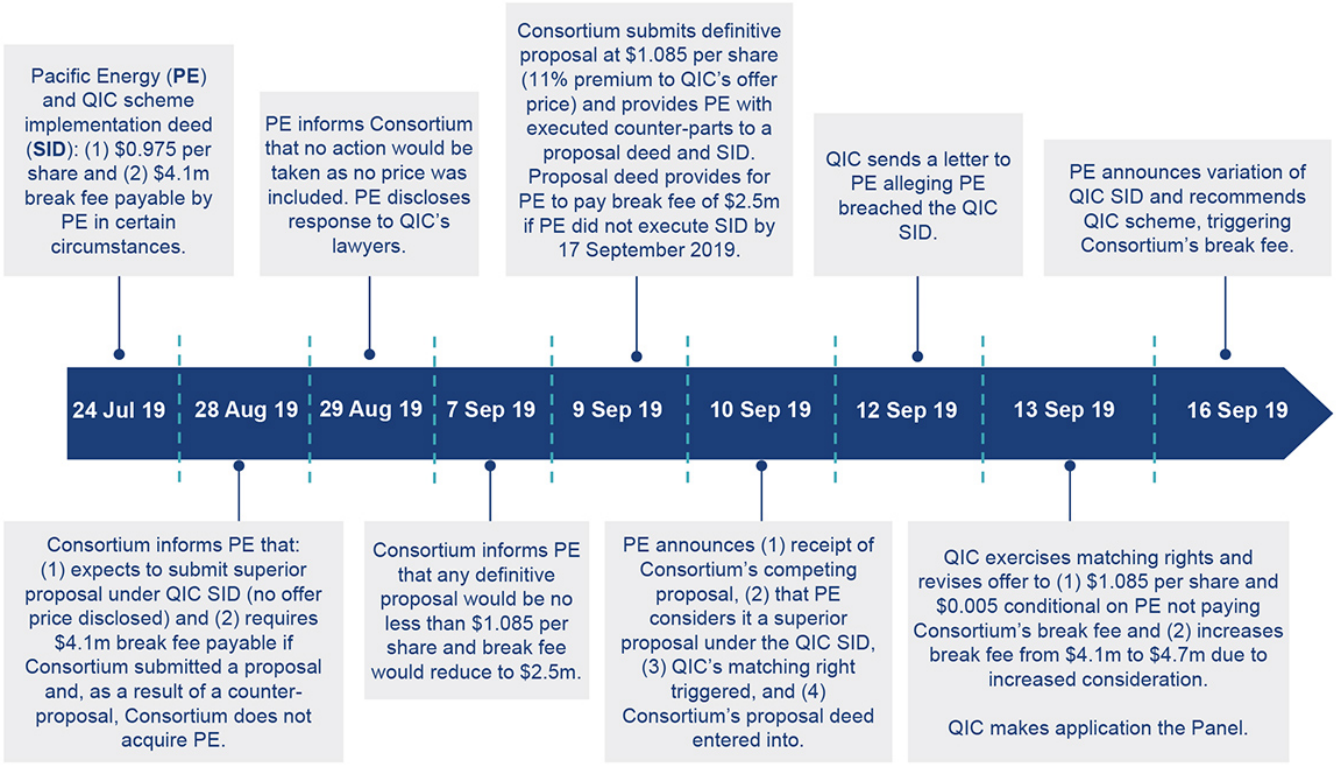
IN BRIEF
• The Panel's decision in *Pacific Energy Limited* [2019] ATP 20 reaffirms the primacy of target boards in determining the optimal strategy for responding to control transactions and the Panel's reluctance to second guess boards.
• More generally, the auction for control of Pacific Energy speaks to a continuing trend of market participants departing from traditional transaction processes.

BACKGROUND

On 24 July 2019, Pacific Energy Limited and Queensland Investment Corporation (**QIC**) agreed terms for the acquisition of Pacific Energy via a scheme of arrangement.

QIC subsequently made an application to the Panel concerning the conduct of Pacific Energy in connection with a competing proposal received from a consortium comprised of OP Trust and Infrastructure Capital Group (**Consortium**).

Set out below is a high-level timeline of events leading to QIC's application to the Panel:



QIC's application to the Panel contended that:

- since at least 28 August 2019, the Consortium had engaged with Pacific Energy with the clear intention of inducing Pacific Energy to breach the QIC SID; and
- entry into the Consortium's proposal deed:
    - constituted a wilful breach of the QIC SID by Pacific Energy;
    - was inconsistent with Pacific Energy's publicly disclosed intentions with respect to

QIC's proposal and any competing proposal; and

- reduced Pacific Energy's assets by the amount of the Consortium's break fee.

QIC argued that the above circumstances had hindered the acquisition of control of Pacific Energy taking place in an efficient, competitive and informed market.

THE TAKEOVER PANEL'S DECISION

Ultimately, the Panel concluded that Pacific Energy had facilitated a materially higher offer and there was little to warrant the Panel second guessing the Pacific Energy board's approach.

However, in view of the Panel regarding certain features of the transaction process as being unusual, the Panel decided to conduct proceedings.

We have considered below each of the key issues raised in the Panel's reasons.

- **Wilful breach of the QIC SID**: QIC argued that the entry into the proposal deed, prior to the expiry of the matching right period and in breach of the QIC SID, denied QIC of the benefit of its matching right. QIC contended that there would be a significant adverse effect on the competition for control if bidders could not rely on such deal protection mechanisms.

  QIC also argued that market participants should be entitled to rely on publicly disclosed contractual obligations.

  The Panel rejected these arguments.

  The Panel concluded that there is nothing that gives a matching right "any special place in the market for control beyond its contractual terms" and noted the contractual rights commonly open to a bidder in the event of a competing proposal (i.e. match or terminate and, in the event of a breach, collect a break fee).

  In relation to the Consortium's break fee, the Panel concluded that the break fee was not anti-competitive or coercive; rather, the Panel determined that the break fee was necessary for the Consortium to offer an 11% premium to QIC's initial price.

- **Reduction in Pacific Energy's assets**: QIC argued that the Consortium's break fee would frustrate QIC's ability to match the Consortium's offer (given that QIC would be required to pay more for less assets) at the expense of Pacific Energy shareholders.

  The Panel rejected this argument, noting that QIC did deliver an 11% premium to its initial price as a result of the Consortium's proposal.

- **Trigger for the Consortium's break fee**: The Panel considered whether the trigger for the Consortium's break fee being payable (i.e. the Consortium's SID not being entered into by 17 September 2019) was unacceptable and concluded that it was not. The trigger for the Consortium's break fee was in substance equivalent to the trigger for QIC's break fee in that they both in effect relate to a payment being made if a transaction does not occur. Moreover, the Panel concluded that the structure of the Consortium's break fee preserved the substance of QIC's matching right.

- **Proposal deed fettered Pacific Energy**: ASIC argued that several aspects of the Consortium's proposal unduly fettered Pacific Energy's ability to achieve an optimal outcome (e.g. the Consortium's offer being contingent on the proposal deed being executed, the proposal deed being executed 1 day after the definitive proposal was made to Pacific Energy and matching right obligations under the QIC SID only arising after the proposal deed was executed).

  The Panel rejected this argument, noting that the evidence demonstrated that the Pacific Energy directors had adequate time to consider the proposal and, in the Panel's view, the risk fell largely on the Consortium (noting that it did not have the benefit of any deal protection mechanisms between signing of the proposal deed and a SID).

- **Aggregation of break fees**: ASIC argued that QIC's uplifted break fee and the Consortium's break fees should be aggregated for the purposes of the Panel's 1% guideline on break fees.

The Panel did not accept this argument, noting that QIC's uplifted break fee should not coerce Pacific Energy shareholders given that the fee would not be payable if Pacific Energy shareholders do not approve the scheme.

Moreover, the Panel chose not to consider the effect of an aggregated fee on a third party bidder, given that no third party bidder had emerged in this scenario.

COMMENTARY

The Panel's decision in *Pacific Energy* reaffirms the Panel's pragmatic approach of assessing deal protection devices with reference to whether the device secures, or deters, proposals and the relevant target board's reasons for being satisfied as to the benefits of the device for target shareholders.[1]

In the last 12 months, we have seen a marked uptick in the use of innovative mechanisms that give certainty to preferred bidders and lock in acceptable terms, but also seek to facilitate auctions and, ideally, secure higher offers. Examples include the use of "go shop" provisions, process deeds, and concurrent schemes and takeovers.

The Consortium's proposal deed represents a continuation of this trend.

The Panel's principled approach to the assessment of the Consortium's proposal deed should further foster this trend and reflects the primacy of the target board's role in achieving optimal, negotiated outcomes for shareholders.

In our view, whilst it is unappealing for market participants to wilfully breach their contractual obligations, the appropriate response to this risk is market-based, rather than regulatory.

Watch for bidders to employ new and creative means by which to enhance deal certainty, whether by way of value or other deal terms, which could lead to more matters coming before the Panel.

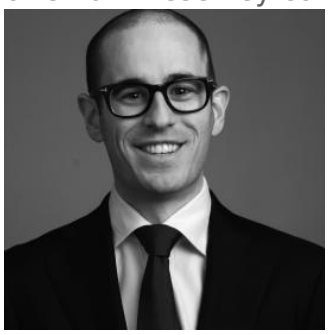
In the case of break fees, one such potential scenario is a bidder becoming entitled to more than 1 break fee (as a result of having made multiple recommended, yet ultimately unsuccessful, offers) or break fees becoming payable to more than 2 unsuccessful bidders. In these scenarios, the Panel may well be called on to decide whether and, if so, how such fees should be capped.

ENDNOTES

1. *Guidance Note 7: Lock up devices*, [6]-[8], [18].

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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