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DIRECTOR RECOMMENDATIONS IN SCHEMES: END OF THE SAGA?

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Legal Briefings – By **David Gray and Panashi Devchand**

Clarity is beginning to emerge in the courts' approach to director recommendations in schemes of arrangement where a director stands to receive a bonus on implementation of the scheme (or has some other interest in the outcome of the scheme).

IN BRIEF

• The last few months have seen various courts around the country focus on the role of target directors who stand to receive a bonus on implementation of a scheme of arrangement (or have some other interest in the outcome of the scheme).
• In August, we reported that the Federal Court considered that the law ordinarily expects directors to make a recommendation to shareholders as to how to vote on a scheme and that the appropriate way to deal with the directors' interests is to ensure that they are properly disclosed to shareholders.[1] This decision, in *Re Kidman Resources Limited* [2019] FCA 1226, rejected the position previously put forward in *Re Gazal Corporation Limited* [2019] FCA 701 and *Re Ruralco Holdings Limited* [2019] FCA 878.[2]
• A recent decision in the Supreme Court of New South Wales has affirmed the approach taken by the Federal Court in *Kidman*, providing clarity on the courts' likely approach to this issue.

WHAT HAPPENED?

In *Gazal*, Farrel J suggested that, in general, interested directors should not join in a recommendation of a scheme to target shareholders.

A few weeks later in *Kidman*, O'Callaghan J respectfully disagreed with the approach taken in *Gazal*, noting that in his Honour's view, the Corporations Regulations ordinarily require directors to make a recommendation, one way or the other, whether they stand to gain if the scheme is approved or not. His Honour considered that the appropriate way to deal with a bonus or other interest is to ensure that it is sufficiently explained to shareholders in the scheme booklet.

Gazal was also considered in the Supreme Court of Western Australia by Vaughan J in *Re Nzuri Copper Ltd* [2019] WASC 189 (which involved a cash bonus payable to Nzuri's CEO and COO if Nzuri shareholders approved the scheme). As we reported in June, Vaughan J was prepared to make orders convening the scheme meeting despite the executive directors joining the recommendation, but his Honour may re-examine these issues at the final court hearing (which is currently scheduled for mid-October subject to deal conditions being satisfied).[3]

VILLA WORLD

Following *Kidman*, there remained a degree of uncertainty as to how other Australian courts would respond.

Earlier this month in *Re Villa World Limited* [2019] NSWSC 1207, Black J noted the differing view of the courts (in particular, in *Gazal* and *Kidman*) but ultimately concluded that his Honour preferred the approach in *Kidman*. The issue in question in *Villa World* was whether its CEO could properly make a recommendation in respect of the scheme when his performance rights would vest if the scheme became effective. His Honour highlighted three key reasons for preferring the approach in *Kidman*:[4]

- First, the Corporations Regulations require a director to make a recommendation and give reasons for doing so, unless the director does not feel justified in doing so.
- Second, his Honour was not persuaded that there is, or should be, a general rule that a director should not make a recommendation on the basis of an interest in the outcome of the scheme.
- Third, and perhaps most significantly from a practical perspective, his Honour acknowledged that there will be many cases in which an interested director would properly participate in the board's decision regarding the scheme, as distinct from any decision about how that director's interest should be treated if the scheme is implemented. This could be because the interest is not a material personal interest for the purposes of section 195 of the Corporations Act (or falls within an exception in section 195(1A) of the Corporations Act) and the company's constitution permits the director's participation in the board's decision in these circumstances, or because the other directors have authorised the interested director's participation in the board's decision as contemplated by section 195(2) of the Corporations Act.

Black J has since confirmed this view in *Re GBST Holdings Limited* [2019] NSWSC 1280, where there were similar circumstances relating to the recommendation of the CEO and managing director of GBST who also held incentives that would vest if the scheme became effective.

In ASIC's latest corporate regulatory activity report,[5] ASIC noted that where a director will receive a contingent benefit in connection with a scheme, that director should carefully consider whether the benefit means that it may be appropriate for that director to refrain from making a recommendation or to explain their decision. ASIC reiterated that directors have an important role representing shareholders' interests but must carefully consider the implications of any conflict of interest in this role in the context of their fiduciary duties.

The existence of director conflicts of interest and the processes required to manage these conflicts in the ordinary course of board decision-making are well entrenched matters of good corporate governance in Australia. We welcome the express acknowledgement by Black J of these matters in the context of the Court's consideration of director recommendations in schemes.

It is worth noting that the courts are, however, very much aware of the inherent conflicts of interest that directors face. Justice Jagot gave a reminder of this in the Federal Court only a few days ago.[5] Her Honour noted that 'it must be recalled that the no conflicts covenant is not about avoiding conflicts of interest. Conflicts of interest are inevitable. It is about managing conflicts of interest. And the conflicts which need to be managed are actual conflicts which have the capacity to significantly impact on the duty to act in the best interests of beneficiaries. Potential or theoretical conflicts of interest are not to the point.'[6]

Although this statement was made in the context of provisions of the *Superannuation Industry (Supervision) Act 1993* (Cth), there are helpful parallels that can be drawn with the position of target boards in considering a scheme and the interests of the target shareholders.

WHAT NEXT?

In *Villa World*, Black J concluded that 'where a director was entitled to and did participate in a decision that a company should go forward with a scheme, there would be little utility and real inconsistency in then preventing that director from making a recommendation to shareholders consistent with the view that he or she took as a member of the board, subject to appropriate disclosure of his or her personal interest in the explanatory materials for the scheme'.[7] In doing so, his Honour provided clarity on the courts' approach to interested target directors joining in recommending a scheme to the target shareholders.

But the saga may not be over just yet. We await the decision of Vaughan J at the final court hearing for the Nzuri Copper Ltd scheme to see whether his Honour follows suit.

ENDNOTES

1. ‘Director recommendations in schemes revisited’, published on 30 August 2019.

2. ‘Now it’s personal: The role of target directors with a bonus linked to the outcome of a scheme’, published on 28 June 2019.

3. Earlier this month in *Re MOD Resources Ltd* [2019] WASC 326, Vaughan J acknowledged that there is a divergence of views on this issue. However, his Honour concluded that this case was not an appropriate occasion to enlarge or seek to reconcile the debate (at [86]).

4. At [34] to [40].

5. ASIC Report 630: ASIC regulation of corporate finance: January to June 2019.

6. *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521.

7. At [79].

8. At [40].

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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