

NO SMOKE WITHOUT FIRE: INSIDER PARTICIPATION IN RESCUE TRANSACTIONS

31 January 2020 | Australia
Legal Briefings - By **Andrew Rich and Li-Lian Yeo**

The Takeovers Panel recently declared unacceptable circumstances in relation to the affairs of Smoke Alarms Holdings Limited because it considered that appropriate protocols were not implemented to deal with the participation of an insider in the negotiation of a control transaction. In the Panel's view, the issue was further compounded by the lack of an independent expert's report in the meeting materials despatched to shareholders. In this article, we summarise the key findings from the Panel.

IN BRIEF

- The Panel's decision is a reminder that appropriate protocols and procedures should be established at the outset to manage potential or actual conflicts that may arise as a result of control proposals involving a participating insider.
- The Panel's Guidance Note 19 "*Insider Participation in Control Transactions*" (**GN19**) sets out the Panel's current suggestions on appropriate protocols.
- An independent expert's report can mitigate the issue of information asymmetry between participating insiders and shareholders where there are potential or actual conflicts of interest.

BACKGROUND

Smoke Alarm Holdings Limited (**SAH**) entered into a transaction with an entity controlled by one of its directors, Mr Randall Deer (**RD**), involving the issue of convertible notes. RD was also a director of SAH. The convertible notes were convertible into shares and also further options which could be exercised to convert into additional shares. If the various securities were ultimately converted in full into shares, RD could acquire a relevant interest in up to 80.04% of the shares in SAH (subject to shareholder approval under item 7 of section 611 of the Corporations Act).

SAH was in a precarious financial position at the time that the transaction was entered into (October 2019) and evidence was provided that if it did not receive the necessary funding it could be at risk of insolvency by the end of January 2020.

SAH convened a shareholder meeting on 4 December 2019 to seek shareholder approval. At 3pm on the day before the meeting, the Panel received an application seeking a declaration of unacceptable circumstances. The Panel declined to adjourn the meeting and an 87% vote was obtained in favour of the resolution at the meeting.

THE PANEL'S FINDINGS

The Panel made a declaration of unacceptable circumstances on two key bases:

- SAH did not implement protocols and processes to manage the conflicts of interest or potential conflicts of interest; and
- SAH's notice of meeting and explanatory statement was defective because it lacked an independent expert's report and it contained other statements that were potentially misleading.

The Panel required, amongst other things, that:

- any options issued as a result of the conversion of the convertible notes could not be exercised unless further SAH shareholder approval was obtained; and
- the meeting materials for this further shareholder approval must contain an independent expert's report and must be provided to ASIC at least 10 business days before it is despatched.

LACK OF PROTOCOLS

Negotiations on the terms of the deal were led by Mr Cameron Davis (one of the three SAH directors) (**CD**) on behalf of SAH. There was some evidence of business relationships between CD and RD beyond just their directorship on SAH. However, the Panel did not make any findings on the question of whether CD and RD were associates.

The Panel found that it was inappropriate for CD to have taken the lead role in negotiations against RD in this context.

While the Panel made no findings about whether or not CD and RD were associates, the Panel made the observation that the relationship was such that appropriate protocols and processes should have been implemented to manage the conflicts of interest or potential conflicts of interest.

SAH's failure to manage conflicts placed doubts in the Panel's mind on:

- whether the terms of the transaction were appropriately negotiated – eg whether the terms were onerous for SAH and its shareholders; and
- whether potential funding alternatives were adequately pursued by SAH. The Panel went so far as to suggest that, in its commercial judgment, other fundraising options were not properly considered.

LACK OF INDEPENDENT EXPERT'S REPORT

There was no independent expert's report that was sent to shareholders to assist them with considering whether or not to approve the relevant resolution.

The Panel's view was that the unacceptable circumstances arising from SAH not properly managing its conflicts could have been partly resolved if there was an independent expert's report.

Without the report, shareholders did not have the benefit of an independent assessment as to whether RD was obtaining control of SAH at a premium or discount.

SAH said their reason for not commissioning a report was that the cost and time delay would be materially detrimental to SAH's financial position.

The Panel was not convinced. Its view was that:

- there was sufficient time for SAH to obtain the report – there were 10 weeks between the term sheet being signed and the meeting being held and 6 weeks between the agreements being signed and the meeting being held; and
- the cost of the report (\$25,000 - \$35,000) was not prohibitive.

The Panel also had other issues with the disclosures in the notice of meeting, but its key concern was the lack of an independent expert's report.

As a separate issue, the Panel also noted that the meeting materials for the item 7 approval should have been accompanied by either an independent expert's report or a sufficiently detailed director's report that complies with ASIC's policy,¹ and the meeting materials were not accompanied by either.

COMMENTARY

Potential conflicts of interest are not uncommon in “rescue” funding transactions for smaller companies, many of which may result in a change of control. Conflicts can arise, for example, where there are “rescue” transactions involving management, directors or major shareholders (such conflicts can indeed also arise in non-rescue transactions).

While there are no set rules for how a company must deal with actual or potential conflicts of interest, it is important to note the Panel's view in GN19.

Identifying potential conflicts of interest and formulating an appropriate framework from the outset mitigates the risk of a transaction being challenged.

Two common options are the establishment of an independent board committee (where there are participating directors) and/or entering into engagement protocols between the bidder and target. The exact protocols a company should adopt to manage conflicts will depend on the nature of the relationship between the participating insider and the company (and those acting on behalf of the company).

Where a potential or actual conflict of interest has been identified, an independent expert's report can be helpful to bridge the informational gap between a participating insider and disinterested shareholders. As noted by the Panel in this case, an independent expert's report could have partly resolved the conflict issues by providing shareholders with enough information for them to undertake their own assessment.

We expect² that 2020 will see a number of “rescue” funding transactions given where Australia is in the economic cycle. The Panel's observations in this case should serve as a useful reminder for market participants looking at similar transactions.

On 30 January 2020, the review Panel affirmed the decision of the initial Panel to make a declaration of unacceptable circumstances.

ENDNOTES

1. See ASIC Regulatory Guide 74: Acquisitions approved by members at [74.29].
2. See item 9 of our “Top 10 Australian M&A Predictions for 2020” by Tony Damian and Andrew Rich on 18 December 2019.

KEY CONTACTS

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



ANDREW RICH
PARTNER, SYDNEY

+61 2 9225 5707
andrew.rich@hsf.com



LI-LIAN YEO
SENIOR ASSOCIATE,
SYDNEY

+61 2 9322 4260
Li-Lian.Yeo@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

SUBSCRIBE TO STAY UP-TO-DATE WITH LATEST THINKING, BLOGS, EVENTS, AND MORE

Close

© HERBERT SMITH FREEHILLS LLP 2020