NOW IT'S PERSONAL: THE ROLE OF TARGET DIRECTORS WITH A BONUS LINKED TO THE OUTCOME OF A SCHEME

28 June 2019 | Australia
Legal Briefings – By **David Gray and James Sippe**

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IN BRIEF

- Courts have recently raised concerns about the role of target directors who stand to receive a bonus on implementation of the scheme – in particular, whether they should recommend the scheme to shareholders.
- The decisions indicate that, despite previous practice, the Courts consider that, in general, interested directors should not join in a board recommendation to shareholders, and that there may be circumstances in which such a recommendation might lead a Court to decline to approve the scheme.
- There are some important takeaways for scheme proponents regarding the disclosures to target shareholders and the terms of the scheme implementation agreement.
- In some recent decisions on schemes of arrangement, Courts have queried the role of target directors who stand to receive a bonus on implementation of the scheme.
- In particular, the Courts have asked whether a director of a target company who stood to receive a bonus on completion of the transaction should make a recommendation to target shareholders as to whether they should approve the scheme.
- In this article, we examine the decisions and the implications for scheme proponents in future schemes

BACKGROUND

Under the Corporations Regulations, a scheme booklet must include a recommendation from each target director as to whether target shareholders should approve the scheme. However, a director may instead state that he or she does not wish to make, or does not consider himself or herself justified in making, a recommendation.

Because of the value of a recommendation from a target board, acquirers typically insist on a unanimous recommendation as a key term of the transaction. Any change in that recommendation typically triggers a termination right and/or a break fee.

In our experience, it is rare for directors to decline to make a recommendation except where there is a conflict of interest or duty – for example, where a director is a director of the target and of the acquirer. The law does not automatically require this, but it appears to be a common practice.

Also, in our experience, it is not uncommon for executive directors to receive bonus payments or have existing incentive securities vest in connection with a change of control transaction.

THE RECENT CASES

THE FEDERAL COURT: *GAZAL* AND *RURALCO*

In *Re Gazal Corporation Limited* [2019] FCA 701, Farrell J approved a scheme under which PVH Corp, a clothing company listed on the NYSE, acquired the remaining shares in Gazal Corporation, a clothing company listed on the ASX, that it did not already indirectly own.

The scheme booklet published by Gazal included a unanimous recommendation by the Gazal board that shareholders approve the scheme. It also disclosed that Patrick Robinson, the Managing Director of Gazal, would receive a cash bonus of $1.7 million if the scheme was approved, approximately 0.6% of the equity value of Gazal implied by the transaction. The scheme booklet described the bonus as recognising Mr Robinson's 'central role in creating value for Gazal Shareholders' through the initial joint venture with a subsidiary of PVH Corp and then the scheme.

At the final Court hearing, when Gazal sought orders to convene the scheme meeting, Farrell J raised concerns about Mr Robinson's bonus payment and required more prominent disclosure of it in the scheme booklet. In particular, her Honour required disclosure of the bonus in all parts of the scheme booklet which referred to the directors' unanimous recommendation.

At the second Court hearing, when Gazal sought orders approving the scheme following shareholder approval, Farrell J raised more general concerns about whether it was appropriate for Mr Robinson to make a recommendation at all given his interest.

In the circumstances, Farrell J was prepared to approve the scheme despite the fact that Mr Robinson made a recommendation. Her Honour noted that the recommendation was supported by the independent expert's conclusion and that the scheme had been overwhelmingly supported by shareholders. However, her Honour indicated that '[s]cheme proponents cannot count on that always being the outcome where an interested director elects to make a recommendation' and that interested directors 'should exercise caution in making recommendations and, in my view, generally should not do so'.[1] Her Honour did note that she saw no issue with a director disclosing how they intended to vote their shares at the scheme meeting.

Her Honour again raised these issues *Re Ruralco Holdings Limited* [2019] FCA 878, the first Court hearing for a proposed scheme under which Nutrien, a crop supplier listed on the TSX and NYSE, would acquire all the shares in Ruralco, an agricultural services business listed on the ASX.

Like Gazal, the scheme booklet that Ruralco proposed to send its shareholders included a unanimous recommendation by the Ruralco board that shareholders approve the scheme. It also disclosed that Travis Dillon, the Managing Director of Ruralco, stood to receive a cash payment of up to $2,460,375 if the scheme was approved.

Mr Dillon also held certain incentive securities which would convert into Ruralco shares if the scheme became effective.

Farrell J rejected a submission from Ruralco that sought to distinguish the payments to Mr Dillon from the bonus payable to Mr Robertson by Gazal. Her Honour characterised the payments as dependent on shareholder approval of the scheme and as having an incentive effect supportive of the scheme.

Despite this, Farrell J made orders allowing dispatch of the scheme booklet to shareholders, on the basis that there was adequate disclosure of Mr Dillon's interest proximate to all references to the recommendation save for the front cover. However, her Honour noted that a bare statement of a recommendation in other contexts, such as in telephone canvassing, might lead her at the final Court hearing to decline to approve the scheme because it could not be assured of the integrity of the outcome of the vote. Her Honour noted, rather pointedly, that all this could be avoided if Mr Dillon simply declined to make a recommendation.

THE WA SUPREME COURT: *NZURI COPPER AND NAVITAS*

In *Re Nzuri Copper Ltd* [2019] WASC 189 – which was heard after *Gazal* but before *Ruralco* – Vaughan J made orders approving the convening of a scheme meeting to consider the proposed acquisition of Nzuri, a copper miner listed on the ASX, by Xuchen International Ltd.

The scheme booklet that Nzuri proposed to send to its shareholders included a unanimous recommendation by the Nzuri board that shareholders approve the scheme. It also disclosed that Mark Arnesen, Nzuri's CEO, and Adam Smits, the COO, each stood to receive a cash bonus of $240,000 if shareholders approved the scheme.

Nzuri had further proposed that Mr Arnesen serve as chair of the scheme meeting, and Mr Smits was proposed as the alternate chair.

Vaughan J declined to make orders that Mr Arnesen serve as chair and Mr Smits serve as alternate chair of the scheme meeting. Although acknowledging it might seem overly cautious, his Honour noted that the test for apprehended bias is an objective test of possibility, not probability, and his Honour considered it prudent to remove any doubt as to whether Nzuri shareholders might have a reasonable apprehension of bias on the part of the chair of the scheme meeting.

Vaughan J also had regard to Farrell J's observations in *Gazal* in declining to make the orders regarding the chair of the scheme meeting. His Honour went on to record that he was prepared to make orders convening the scheme meeting despite the fact that Mr Arnesen and Mr Smits joined the recommendation to shareholders on the basis that:

- the amount, one year's salary, was not commercially unreasonable and arose under contracts executed well before the transaction
- the interest was linked to the possibility that the executives' employment would be terminated immediately after a change of control, and their contracts did not entitle them to notice of termination or payment in lieu of notice if terminated within six months after a change of control; and
- the interest was fulsomely and prominently disclosed in the scheme booklet.

His Honour will presumably re-examine these issues at the final Court hearing if Nzuri shareholders approve the scheme.

Since his Honour's decision in *Nzuri*, Vaughan J has also heard an application for final approval of the scheme under which BGH Group will acquire Navitas Limited in *Re Navitas Ltd (No 2)* [2019] WASC 218. His Honour referred to the above decisions and determined that:

- exertion payments that were payable to non-executive directors of Navitas regardless of whether the scheme was approved did not present an issue for the Navitas board's recommendation; and
- a $750,000 payment due to Navitas' managing director, David Buckingham, that was accelerated if the scheme was approved did present an issue but, in the circumstances, was not a sufficient reason to decline to approve the scheme. His Honour noted that the

interest was properly disclosed, there was a reasonable commercial rationale for the benefit, and Mr Buckingham was just one of six directors. In conclusion, his Honour stated that he 'could not identify any real possibility that Mr Buckingham's joinder in the recommendation … might have affected the integrity of the outcome of shareholders' resolutions to agree to the proposed scheme'.

WHAT DOES THIS MEAN FOR SCHEMES?

The key practical takeaway for scheme proponents is that Courts expect fulsome and prominent disclosure of any bonuses payable to, or other entitlements or interests of, a director that are linked to the outcome of the scheme.

In particular, although to us it seems unnecessary repetition, the Court will expect to see this disclosure at every point in the scheme booklet – and, it seems, in every other communication with shareholders relating to the scheme – that refers to or summarises the directors' recommendation.

However, the decisions also state that, in general, interested directors should not join in a recommendation of a scheme to target shareholders. Despite this, the Courts have not yet rejected a scheme because of a recommendation by an interested director – in fact, the Courts identified clear reasons why the recommendation was not an issue in the Gazal and Navitas schemes, many of which would apply to any number of schemes that come before the Courts for approval.

This leaves scheme proponents in an unsatisfactory and difficult position for future schemes agreed after Gazal and the subsequent decisions.

In our experience, bonuses, retention payments and accelerated vesting of incentive securities feature regularly in public M&A transactions. The intention is to incentivise the directors to deliver a change of control transaction – one which is likely to result in the director losing his or her job – that delivers value to all of the company's shareholders. These entitlements do not relieve the director of the duty to act in the best interests of the company and to act for a proper purpose. The law frequently accepts that directors can have competing interests but still act in accordance with these fundamental duties. Indeed, as acknowledged by Vaughan J in *Navitas*, a number of schemes have previously been approved despite a recommendation by an interested director and without comment by the Courts.

As a result, we would have considered that proper disclosure to shareholders of these interests would, in general, be the appropriate way to address the issues identified by the Court (rather than excluding the relevant director from giving a recommendation). The decision of whether or not to approve the scheme is still in shareholders' hands. Shareholders are very capable of assessing the disclosures and taking the interests into account when considering the board's recommendation and how to vote on a proposed scheme.

To us, this seems consistent with Farrell J and Vaughan J's reasons for approving the Gazal and Navitas schemes. Importantly, however, despite approving those schemes, both decisions give a clear indication that, in general, interested directors should not join a recommendation and that there may be circumstances in which a Court will reject a scheme on the basis that a target director's recommendation undermined the integrity of the shareholder approval process. It may be that the circumstances of a bonus payment – eg its size relative to the value of the deal – or of the deal – eg where the expert has given a 'not fair but reasonable and therefore in the best interests of shareholders' conclusion and the vote only narrowly passes by the required majorities – could lead a Court to decide not to approve a scheme. It is also worth noting that, in approving the scheme before the Court despite the recommendation by an interested director, Vaughan J in *Navitas* appeared to give some weight to the fact that the scheme was agreed before Farrell J's decision in *Gazal.* His Honour noted that, in the future, practitioners should have regard to *Gazal*.

Scheme proponents will therefore need to carefully consider the likely attitude of the Court when structuring a transaction and the related shareholder disclosures.

Interestingly, the decisions reviewed above left open related legal questions regarding the relevant director's interest, including:

- Whether the interest constituted a material personal interest that, under section 195 of the Corporations Act, should have prevented the relevant director from voting at board meetings on the scheme at all, unless the other directors authorised the director to vote.
- Whether an interest that, in the Court's view, should result in a director abstaining from making a recommendation is such that the director should also abstain from approving the execution of the scheme implementation agreement at board level.
- Whether the director's interest – described by Farrell J in *Ruralco* as 'both material and different from that of other shareholders' – had any implications for the composition of shareholder classes (which is unlikely),[2] or at least went to the Court's discretion to discount or disregard votes cast on the scheme because of an extraneous interest. Only Vaughan J's reasons expressly addressed the issue of class composition, noting that the interests held by the CEO and the COO of Nzuri did not require them to be placed in a separate class.

It remains to be seen if these issues are ventilated at future scheme Court hearings. We also expect there to be implications for scheme implementation agreements – given the Court's focus on this issue, scheme proponents will need to carefully consider the obligations on the target to procure a unanimous board recommendation.

We do not expect Vaughan J's other ruling, regarding the role of the chair at a scheme meeting, to be a material practice point, as typically a non-executive director would serve as chair of a shareholders' meeting.

ENDNOTES

1. At [30].
2. The view of the Courts in similar contexts has been that separate class are not required: see, eg, *Re Centrebet International* [2011] FCA 870; *Re Aston Resources Ltd* [2012] FCA 229; *Re Viking Industries Ltd* [2008] QSC 31.

KEY CONTACTS

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

DAVID GRAY
PARTNER, PERTH

+61 8 9211 7597
david.gray@hsf.com

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