HERBERT SMITH FREEHILLS

POST-DEAL DUE DILIGENCE IN AUSTRALIAN PUBLIC M&A TRANSACTIONS

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Legal Briefings – By **Rodd Levy** and **Courtney Dixon**

SUMMARY

- Post-deal due diligence has been a feature of a number of agreed public company M&A transactions, including recently Japan Post's $6.5 billion acquisition of Toll Holdings.
- Post-deal due diligence may allow the parties to quickly negotiate and announce a deal and, in doing so, mitigate the risk of their deal leaking and limit management interruption and distraction.
- Deal dynamics will heavily influence the appropriateness of agreeing a post-deal due diligence regime.

WHAT IS POST-DEAL DUE DILIGENCE AND WHEN DOES IT MAKE SENSE TO AGREE TO A POST-DEAL DUE DILIGENCE REGIME?

Post-deal due diligence typically involves the parties to a public M&A transaction completing a first phase of due diligence and then executing a formal transaction agreement, which provides for a further period of due diligence (often described as 'confirmatory due diligence') after the formal implementation agreement is executed.

This may be appropriate where the parties have concluded that the risk of a material unforeseen issue emerging post signing is limited. A strong premium over the share price may have been offered - indicating the bidder's seriousness and increasing the target board's willingness to put the transaction to its shareholders.

The key advantage of this approach for the bidder is to lock the target into a formal implementation agreement earlier than may be possible compared to the normal situation where the bidder must first complete extensive due diligence. For the target, a post-deal due diligence arrangement will bind the bidder to proceed earlier and will enable further due diligence to be conducted free of the risk of the transaction leaking.

Transaction conditionality should be limited to only necessary conditions (no 'free options'), and the risk of an interloper emerging in the post-deal due diligence period should be low. Sometimes, as the table below shows, post-deal due diligence may be used to 'bridge the gap' between a domestic target and a foreign bidder - the latter potentially being accustomed to a more exhaustive or protracted approach to due diligence; which doesn't necessarily suit the Australian listed company environment.

The following are examples of agreed public company transactions[1] which included a post-deal due diligence regime:

Target (Bidder)	**Due diligence period**	**Bidder termination right arising from new information identified in due diligence**
Toll (Japan Post)	As soon as practicable after announcement	Only if the new information triggers a 'material adverse change'
Graincorp (Archer Daniels Midland)	7 days	The new information would have caused the bidder not to have bid or to have bid on materially less favourable terms
Gloucester Coal (Yanzhou Coal)	2 months	If due diligence results in an unresolved dispute in relation to relative values of merger parties[2]
Lihir Gold (Newcrest)	1 month	If due diligence discloses a major adverse discrepancy which reduces value of the target above specified threshold
AXA APH (AMP)	10 business days	If a 'material adverse change' occurs or becomes known during due diligence[3]
OZ Minerals (China Min-Metals)	8 days	If the bidder becomes aware of any 'material adverse change' during due diligence
Sino Gold (Eldorado)	14 days	Condition precedent that no 'material adverse change'[4]
Dyno Nobel (Incitec Pivot)	10 days	If due diligence discloses a diminution (above specified thresholds) of the target's consolidated net assets or recurring annual EBITDA
Bolnisi Gold (Coeur d'Alene Mines Corporation)	44 days	Condition precedent that no 'material adverse change' or a liability above a specified threshold

HOW DOES POST-DEAL DUE DILIGENCE WORK IN PRACTICE?

Even in a 'friendly' deal context, a pre-deal due diligence process can be a source of frustration to both parties – the bidder often requires more information, the target often wishes to provide less information, and both parties may try and influence the timetable to reflect their own preferences.

The other real factor at play in a public company environment is that the longer the pre-deal due diligence period, the greater the risk of deal leaks. A leak can mean the parties can no longer rely on the listing rule carve-out to disclosure, while also potentially exposing the deal to interloper risk and the vagaries of the stock market. Finally, the target’s management often bears the brunt of pre-deal due diligence – they face considerable interruption and distraction throughout the process.

In our experience, the announcement of an agreed deal usually changes the transaction dynamic. Parties are keen to close the transaction – outstanding due diligence will be narrowed in scope, the bidder will only focus on what really matters, rather than adopting a 'shopping list' approach often seen pre-deal. Further, the target’s management - under the watch of their ‘new owner’ - may approach information requests more positively and try and resolve outstanding items more quickly.

WHAT HAPPENS IF SOMETHING MATERIAL IS UNCOVERED IN POST-DEAL DUE DILIGENCE?

There will always be the risk of something material being uncovered in post-deal due diligence which could scuttle the transaction. However, as noted above, in almost all post-deal due diligence situations, a limited amount of pre-deal due diligence will have been performed and the parties will have assessed the risk of an unforeseen issue emerging as being relatively limited.

The examples above show that bidders have generally taken most of the risk of something emerging in the post-deal due diligence. Unless the new information triggers the standard material adverse change (**MAC**) termination right (which right would also be triggered by matters unrelated to the due diligence), the bidder would generally have limited remedies if new information arises in post-deal due diligence.

Another approach is to agree to a variation on the form of a MAC – a breach of specific value thresholds. The least favourable position for a target would be a relatively undefined termination right – the Graincorp / Archer Daniels Midland example above is almost in this category.

OTHER APPROACHES TO DUE DILIGENCE IN PUBLIC M&A – 'PROCESS AGREEMENTS', 'CONDITIONAL TAKEOVER AGREEMENTS' AND 'IN-PRINCIPLE AGREEMENTS'

Another approach we have seen parties adopt is to announce their entry into a 'process agreement' or 'conditional agreement' – in effect, the parties announce their intention to pursue a transaction, but in circumstances where they haven't yet completed their due diligence nor agreed definitive documentation. Examples include: Ludowici / FLSmidth & Co,[5] Lion Nathan / Kirin and St.George / Westpac.

In MSF Sugar / Mitr Phol Sugar, the parties announced that they had entered into a conditional takeover implementation agreement – if after two weeks of due diligence Mitr Phol was satisfied with the outcome, then it would proceed with its offer.

There can be a different dynamic in these deals – due diligence takes on more prominence, as it is often a trigger for the parties formally agreeing transaction terms and proceeding with the transaction. Therefore, the due diligence process and findings can have a greater influence on deal terms. Timelines can drift as the parties want to make sure they have covered off all due diligence items before signing definitive terms and there is greater scope for interloper and market risk.

More recently, Recall and Iron Mountain announced on 29 April 2015 that they had reached an 'in principle agreement', under which they agreed, amongst other things, to use reasonable best efforts to complete reciprocal, confirmatory due diligence and enter into definitive documentation. A formal implementation agreement was later entered into on 8 June 2015.[6]

COMMENTARY

Due diligence before launching a takeover bid or scheme of arrangement is almost ubiquitous these days as boards and their financiers remain risk averse. Carrying out some of the due diligence after executing a formal implementation agreement under a carefully set out regime can reduce stress for the bidder and the target as they will have the comfort of a signed, and announced, agreement and will no longer be concerned about confidentiality.

Our experience in advising bidders and targets involved in these situations suggests that this approach can help the parties to reach a binding implementation agreement on acceptable terms much sooner than might otherwise be the case.

ENDNOTES

1. In each of these transactions, the parties had entered into a takeover, scheme, merger or merger proposal implementation agreement. Herbert Smith Freehills acted for: Toll Holdings on its takeover by Japan Post, Yanzhou Coal in relation to its merger with Gloucester Coal, AXA S.A in relation to AMP's takeover of AXA APH and divestment of its Asian business to AXA S.A, OZ Minerals in relation to the announced transactions with China Min-Metals, Eldorado on its takeover of Sino Gold and Coeur d'Alene Mines Corporation on its takeover of Bolnisi Gold.

2. AXA APH and AMP could terminate if in the course of continuing due diligence, there was an unresolved dispute in relation to the relative values ascribed to either party under the merger terms.

3. Either party could terminate if a material adverse change had occurred or become known in respect of the other party.

4. Either party could terminate if a material adverse change had been disclosed in respect of the other party.

5. Herbert Smith Freehills acted for The Weir Group plc in relation to its competing proposal to acquire Ludowici.

6. Herbert Smith Freehills is acting as independent legal adviser to the Recall board of directors.

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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