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CONTROL EFFECTS OF UNDERWRITTEN RIGHTS ISSUES: TAKEOVERS PANEL'S DECLARATION OF UNACCEPTABLE CIRCUMSTANCES IN RELATION TO ERA

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

The Takeovers Panel (**Panel**) has, on review, affirmed the initial Panel's declaration of unacceptable circumstances in relation to the affairs of Energy Resources of Australia Limited (**ERA**).

In brief

• It is not uncommon for a major shareholder to underwrite an entitlement offer by a listed company. Indeed, an acquisition of a relevant interest in voting shares resulting from a rights issue is expressly permitted as an exception to the '20% prohibition' in section 606 of the *Corporations Act 2001* (Cth) (**Corporations Act**).[1]

• However, the Panel has, on review, affirmed the initial Panel's declaration of unacceptable circumstances in relation to ERA's pro-rata renounceable entitlement offer (which was fully underwritten by a wholly owned subsidiary of ERA's largest shareholder, Rio Tinto[2]).

• The Panel's decision ultimately rests on the particular offer structure and the governance arrangements established by ERA to consider the offer and possible funding alternatives. In any event, the decision still provides a useful reminder of the practical arrangements that the Panel (and ASIC) will expect a listed company to have in place when considering a transaction with significant control implications.

THE OFFER

On 15 November 2019, ERA announced a pro-rata renounceable entitlement offer of 6.13 ERA shares for every 1 ERA share held to raise up to approximately $476 million to fund ERA's Ranger Project Area rehabilitation obligations (**Offer**). Rio Tinto, through wholly owned subsidiaries, had voting power in ERA of approximately 68.39%.

The Offer was fully underwritten by North Limited, a wholly owned subsidiary of Rio Tinto (**Underwriter**). Rio Tinto also committed to subscribe for its entitlement in full.

The underwriting agreement contained a number of undertakings from ERA in favour of the Underwriter, including undertakings regarding use of funds from the Offer (for rehabilitation purposes) and undertakings not to deal with or create any economic or legal interest in certain ERA assets without the Underwriter's consent. These undertakings effectively continued until completion of ERA's rehabilitation obligations (estimated to be January 2026).

Zentree Investments Limited (**Zentree**) (ERA's second largest shareholder) sought a declaration of unacceptable circumstances on the basis that, if the Offer and underwriting proceeded, Rio Tinto would increase its voting power in ERA from approximately 68.39% to up to 95.57%, above the general compulsory acquisition threshold in section 664A of Corporations Act. Zentree submitted that the effect of this was that:

- the acquisition of control by Rio Tinto would not take place in an efficient, competitive and informed market;
- minority shareholders would not receive a reasonable and equal opportunity to participate in the benefits accruing to Rio Tinto; and
- shareholders had not been given enough information to enable them to assess the merits of the Offer and underwriting.

THE PANEL'S DECISION

In December 2019, the initial Panel made a declaration of unacceptable circumstances. In doing so, the initial Panel made orders restricting Rio Tinto's ability to proceed to compulsory acquisition of the ERA shares (ie if it reached the 90% threshold as a consequence of the Offer and underwriting) without obtaining shareholder approval.

In summary, the Panel considered that:

- insufficient measures had been taken to ensure the independence of the independent board committee and potential conflicts of interest were not sufficiently managed;
- the underwriting agreement contained provisions that were not consistent with commercial underwriting arrangements, including provisions that affected aspects of ERA's management and dealings with a major asset of ERA over the medium to long term;
- the Offer was highly dilutive and required shareholders to invest substantial additional capital in order to avoid dilution (and therefore minority shareholders were unlikely to participate); and
- aspects of the disclosure in the Offer information booklet should have more closely reflected the disclosure in a document required for a control transaction regulated by Chapter 6 of the Corporations Act (eg intention statements) given the potential for Rio Tinto to increase its voting power in ERA above 90%.

This month, a review Panel affirmed the initial Panel's declaration of unacceptable circumstances but pared back the orders restricting compulsory acquisition of ERA shares by Rio Tinto. The review Panel considered that these orders were unfairly prejudicial to Rio Tinto and instead required Rio Tinto to provide further disclosure to ERA shareholders of its intentions regarding compulsory acquisition (which Rio Tinto has now done).

We discuss some of the interesting aspects of the Panel's decision below.

INDEPENDENT GOVERNANCE ARRANGEMENTS

In January 2019, the ERA board resolved to form a committee comprising three independent directors to further progress ERA's engagement with Rio Tinto regarding funding options (**Committee**).

The Panel raised a number of concerns regarding the operation of the Committee. The Panel recognised that ERA had a small management team, but considered that ERA should have followed best practice in managing conflicts in the circumstances. The Panel made the following observations:

- ERA's managing director attended each Committee meeting as a member of management, despite not formally being a member of the Committee. The Panel considered that this undermined the purpose of establishing an independent committee and supported an inference that the managing director had a practical ability to make, or at least influence, decisions in relation to the Offer and the underwriting agreement.

- Substantive aspects of the Offer were discussed at meetings of the full ERA board, despite being within the delegated power of the Committee. The Panel considered that this had the potential to compromise the independence of the Committee and the negotiations with Rio Tinto.

- Although the Committee met 15 times, the first meeting occurred after ERA and Rio Tinto had reached an in-principle agreement to conduct a renounceable rights issue fully underwritten by Rio Tinto. In addition, the first meeting occurred a number of months after term sheet negotiations had commenced and no minutes were produced for the Committee's meetings.

The Panel ultimately concluded that insufficient measures were taken to ensure the independence of the Committee and potential conflicts were not sufficiently managed to ensure that the principles in section 602 of the Corporations Act were upheld. In doing so, the Panel reiterated that one of its primary concerns is to ensure that consideration of a proposal by a target board and management is conducted free from any actual influence, or appearance of influence, from participating insiders (noting that the Panel will focus on determining whether unacceptable circumstances have arisen, rather than whether there has been a breach of directors' duties or other obligations).[3]

From a practical perspective, the Panel suggested that the appointment of independent financial advisers to act for the Committee could have assisted by acting as a conduit between management and the Committee to mitigate potential or actual conflicts.[4]

UNDERWRITING AS A FORM OF LOCK-UP

The Panel accepted that ERA's funding situation was unique and that this could justify some of the undertakings affecting the management of ERA. The Panel also acknowledged that the size of Rio Tinto's existing stake in ERA meant that it already had some degree of control over ERA.

However, the Panel considered that the undertakings in the underwriting agreement increased Rio Tinto's effective control (including in circumstances where it did not reach 90% via the Offer or elected not to proceed to compulsory acquisition) and acted as a fetter on the ERA board. The Panel was particularly concerned that the undertaking that ERA would not deal with or create any economic or legal interest in certain ERA assets without the Underwriter's consent effectively operated as a lock-up (as it granted the Underwriter negative control over certain ERA assets).[5] The Panel ultimately made an order that this undertaking was void and of no effect.

COMPULSORY ACQUISITION POST RIGHTS ISSUE

The Panel accepted that Rio Tinto was ERA's controlling shareholder and that it was entitled to act in its own self-interest. The Panel also recognised that it was not necessarily contrary to the equality principle in section 602(c) of the Corporations Act for a shareholder to participate in a rights issue (as a majority shareholder and/or as an underwriter) and be in a position to compulsorily acquire shares from minority shareholders as a result.

The initial Panel accepted that the general compulsory acquisition process in the Corporations Act has its own protections. However, the initial Panel took the view that these protections were not sufficient in the circumstances, highlighting that the right to a Court review can only be exercised if shareholders holding at least 10% of the shares covered by the compulsory acquisition notice object to the acquisition.[6] The initial Panel therefore made orders restricting Rio Tinto's ability to proceed to compulsory acquisition without shareholder approval.

As noted above, the review Panel considered that these orders were unfairly prejudicial to Rio Tinto and instead required Rio Tinto to provide further disclosure to ERA shareholders of its intentions regarding compulsory acquisition (which Rio Tinto has now done). We welcome the approach taken by the review Panel and await with interest the publication of the review Panel's reasons for its decision.

WHAT DOES THIS MEAN?

The Panel recognised that the Offer included a number of features that had the potential to minimise any control impact and facilitate dispersion of the shortfall shares to other shareholders (including that entitlements were renounceable and there was a dispersion strategy in place for any shortfall).

The Panel's decision serves as a useful reminder that, in addition to these features, a listed company should have robust governance arrangements in place (and ensure that it is properly operating in accordance with these arrangements), particularly when considering transactions which have potentially significant control implications. The initial Panel's reasons demonstrate the sheer breadth of information that the Panel may request and consider in determining whether unacceptable circumstances exist.

The decision also highlights the Panel's view on what it considers to be commercial underwriting terms and the circumstances in which undertakings given to an underwriter may be seen to be overreaching as far as Chapter 6 of the Corporations Act is concerned.

ENDNOTES

1. See section 611, item 10 of the Corporations Act.

2. Rio Tinto Limited and Rio Tinto plc.

3. See *Guidance Note 19: Insider Participation in Control Transactions*.

4. The Panel considered that *Yancoal Australia Limited* [2014] ATP 24 was a relevant precedent in this case. In *Yancoal,* independent advisers were appointed to act for Yancoal's independent board committee.

5. For the Panel's general policy on lock-ups, see *Guidance Note 7: Lock-up devices*.

6. See section 664F(1) of the Corporations Act.

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

PANASHI DEVCHAND
SENIOR ASSOCIATE, PERTH
+61 8 9211 7544
panashi.devchand@hsf.com

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