



Directors under siege? Preparing for a takeover bid

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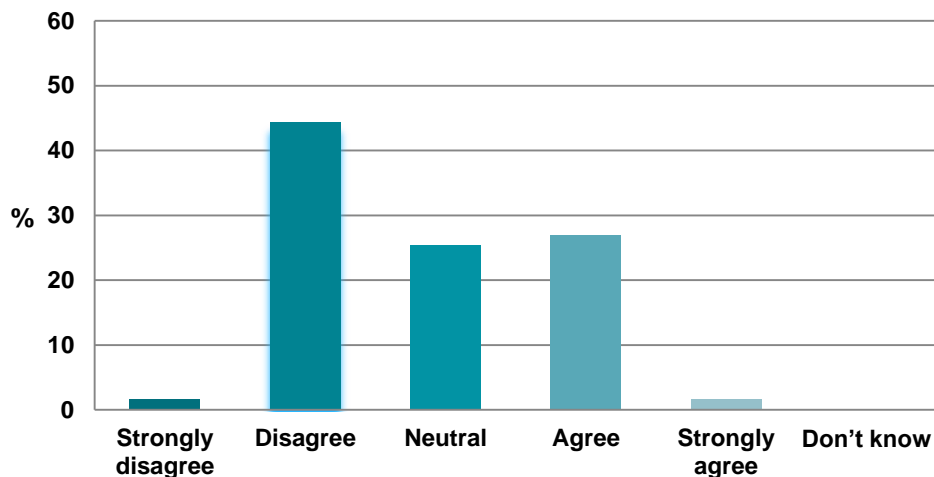
The receipt of a takeover proposal is a critical moment for any listed company. How a company responds in the days, weeks and months that follow will most likely have a profound effect on the value, if any, received by the company's shareholders.

It is important to recognise that the role of the board in responding to a takeover proposal starts long before the receipt of any takeover proposal. Importantly, the actions and conduct of the board in the period leading up to the receipt of any takeover proposal will have a significant impact on the result of any contest for control which develops.

In many cases, a target board may not expect a takeover proposal. Given the potential time required to implement aspects of a company's response, a high performing board should be aware of the steps it should take to be prepared for a potential takeover bid. The focus of this article is therefore on some of the "why" and "how" of takeover response preparation. These issues are relevant for all listed companies, whether big or small. This article also makes a key differentiation between strategic and tactical preparation and the impact that those two things can have.

The context: the view from the top

Before we jump into that, it is interesting to reflect on the results of a survey of non-executive directors of ASX companies we conducted as part of our new book, *Towns Under Siege*. One question asked of directors was as follows: *Do you consider that most companies are adequately prepared for an approach from a bidder proposing a change of control transaction?* The responses to this question are set out in the table below.



¹ Partner and Senior Associate of Herbert Smith Freehills. This article is an edited extract from *Towns Under Siege: developments in Australian takeovers and schemes*, Tony Damian & Clayton James (eds), a new book published by Herbert Smith Freehills in conjunction with Ross Parsons Centre of Commercial, Corporate and Taxation Law of the University of Sydney.

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A significant proportion of respondents, almost half, did not consider that most companies were adequately prepared for an approach by a potential bidder.

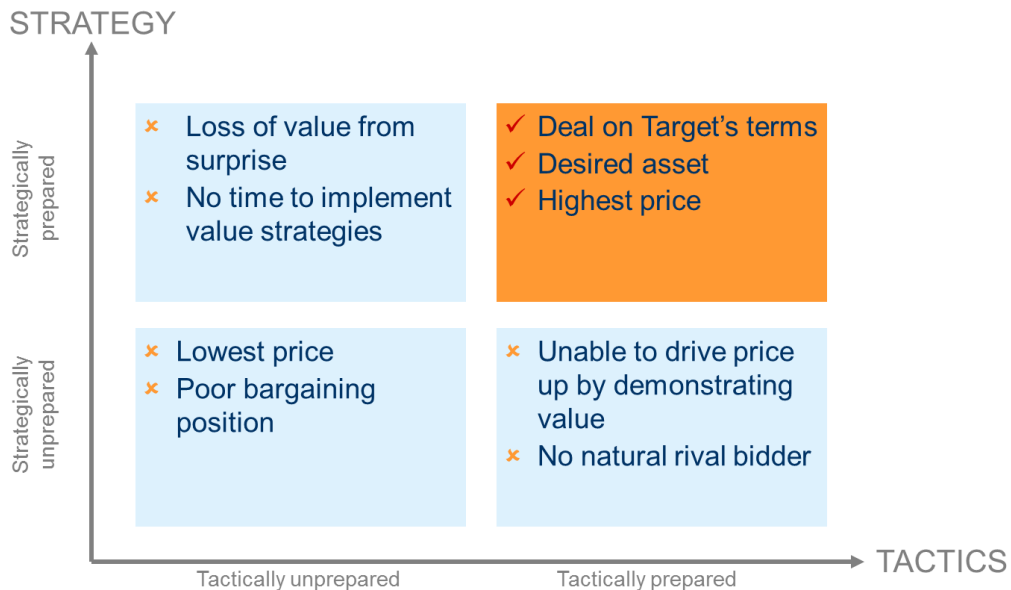
Responses received to the open-ended question reinforced this view, with one respondent noting "I suspect that many Board members do not really know what being ready entails until they are in the thick of things". Likewise, another respondent raised the difficulty of convincing fellow directors to prepare for a possible bid in advance, particularly in preparing and updating a company valuation model.

The "why" of preparation

Before covering the kinds of things that a board can do to prepare for an unsolicited approach, it is worth briefly discussing the "why" of takeover preparation.

It could be argued that there are two elements to an effective takeover response. Those elements are strategy and tactics. Tactics can be said to refer to the short term day-to-day elements of the response, whereas strategy refers to the longer term themes of the response.

It is possible for a target to be tactically prepared, in the sense that it has a response team in place along with draft ASX announcements, but at the same time to be strategically unprepared. A strategically unprepared target would be one that does not have a firm sense of its own value or the thematic response that demonstrates the future value that the bidder must pay for to earn a recommendation or control. Of course, the ideal combination is a target that is both tactically and strategically prepared, as demonstrated by the following diagram.



Strategic preparation

While the tactical preparation considered below is very important in responding to a potential takeover, arguably the most important preparation is the long term strategic preparation taken by the directors and target company.

(a) Demonstrating business performance and value

There is no better preparation for a takeover approach than a company performing well, having a plan to deliver further value to shareholders and having the market aware of, and on board with, both the performance and the plan.



Sustained performance over time both diminishes the risk a bidder will obtain control for less than full value. It also drives board and management credibility - vital commodities in a takeover scenario. Having shareholders on board with plans that deliver further value is important too.

Plans that mysteriously emerge only once an approach is made may be perceived differently to those known and explained beforehand.

(b) A view on value

One of the most important things that a board can do, both as a matter of good corporate practice as well as takeover response preparation, is to have a view on its existing value. The timeframes in takeovers can be relatively tight. If a bidder launches a hostile takeover and simultaneously lodges its bidder's statement, then a target has roughly one month to compile its target's statement (including an expert's report, if one is used). That is a short period of time.

Further, it is in fact probably the wrong period of time to focus on. A board that does not have a clear view on value will not be confident in its response to an initial approach. It is near impossible for a board to delay saying something on its views on an approach until the target statement. A view on value is important to all of these things.

Because of its role in the value question, a board should also consider whether it would be likely to retain an independent expert and, if so, have that expert retained and familiar with the business. It is important to be mindful, however, that the expert must be, and must appear to be, independent when preparing an expert report.

(c) Register composition

Monitoring trading and register composition is important, including from a strategic perspective. It is well settled law that a company cannot issue shares for the purpose of destroying an existing majority (see, for example, *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821). However, there is nothing improper about a board making sure that investors who are likely to appreciate the value in the company are made aware of, if not encouraged, to take a position on the register.

Tactical preparation

The prerequisite to tactical preparation is the desire to be prepared. Once that decision is made, the steps to achieve tactical preparation can be done simply and relatively efficiently.

Descriptions of some of the more important aspects of that preparation are set out below.

(a) The appointment of a response team

It is vitally important that a company have in place a response team well before the clouds of an approach have assembled on the horizon. There are a number of reasons for this.

First, doing this will ensure that the team will have a clear understanding of the company's views on these issues. While there is often a focus on the external elements of a target company's team, the role of the board is a critical one. Often, there will be a sub-committee formed to oversee the day-to-day aspects of any takeover response. The question of whether to use a sub-committee needs to be consciously asked and answered. To the extent the full board agrees that a sub-committee of the board should be in place, thought needs to be given to which individuals on the board fill those roles so that they can be suitably involved in the preparation.

Secondly, this enables the execution of many of the tactical and strategic preparation steps.



Finally, the chaos of an unprepared target descends into tragic comedy if the target has to spend valuable time upon receipt of an unsolicited approach awaiting the responses of the conflict clearance departments of law firms and investment banks. In those valuable hours, much ground can be lost with shareholders and media commentators. It is often difficult to regain that ground once lost.

(b) Preparation of a response manual

While assembling a team is a very good first step, there is ideally some structure around how that team operates, its roles and what is expected of it. These manuals are relatively standard, though need to be tailored to meet the specific circumstances facing the relevant company.

(c) The data room

It is not unusual for a well prepared company to have set up, with varying degrees of comprehensiveness, an electronic data room that contains any materials that the company would wish to show rival bidders in the event an unsolicited proposal came upon it.

It is not hard to imagine the challenges of trying to assemble a data room, and considering whether or not confidentiality restrictions will prohibit the inclusion of some of those materials in such a data room, against the backdrop of an unsolicited approach which is adorning the daily pages of business newspapers.

The data room exercise is not just about confidentiality. By way of example, what are the effects of a change of control? Are there termination rights or expiry periods of major contracts? Does the constitution contain a prohibition on proportional takeovers without shareholder approval?

These questions are ideally considered before an approach is received. The data room review can also cover other basic target diligence issues, such as a review of the constitution and executive service contracts, and option plans to consider the implications, if any, of the change of control proposal.

(d) Regulatory issues

It will usually not be too difficult for a company to consider what regulatory issues would be relevant to a change of control. Forward thinking will be rewarded. Thus, by way of example, it serves a target well to consider the level of any sales into China. That may seem like a curious point to make, but the Chinese competition clearance thresholds turn on gross sales into China, as opposed to having anything to do with market share. The consequence of that is that a takeover of an Australian company (which has sales into China) by another company (which also has sales into China) may require clearance from the Anti-Monopoly Bureau of the Ministry of Commerce. Those clearances can take some time. Knowing in advance that one particular bidder may not trigger that requirement, but another will, is valuable.

(e) Trading and share ownership

Most ASX listed companies keep an eye on trading. It is also open to them from time to time to launch beneficial ownership notice campaigns to discover the identity of those who are holding stakes in the company below the public disclosure threshold of 5%.

(f) Liability issues

A well prepared target will have turned its mind to the liability implications of a takeover for its directors and officers.

A review of the company's directors' and officers' **(D&O)** indemnity deeds, as well as its D&O insurance policies, will reveal any gaps that ought to be addressed. By way of example, many D&O policies contain exclusions that will mean the policy will not respond to certain claims in a takeover context.



(g) *Key stakeholders*

Identifying key stakeholders, and establishing or improving relationships with them, is a useful activity in preparation for any approach.

Those stakeholders can range from shareholders, to regulators and government, to key customers and other business partners, through to media commentators and proxy advisers.

Conclusion

The board of a target company has a vital role in determining the outcome of any approach for a change of control proposal or the takeover that may eventuate from that.

Boards can make a material contribution to the achievement of a superior result for shareholders, while also maintaining the reputation of the company and individual board members. This is achieved through strategic and tactical preparation, a knowledge of and comfort with the parameters within which a takeover response must operate, and a preparedness to imaginatively navigate the issues and challenges that inevitably arise throughout the course of the takeover.



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Towns Under Siege was officially launched by Mr David Gonski, AC. Copies of the book can be purchased from the University of Sydney [here](#).