changing control CAN CAUSE CONFLICTS

Takeover offers often give rise to significant conflicts of interest for senior management. **Colin Galbraith** examines the issues these situations give rise to for directors.

Conflicts of interest and duty affecting directors and senior management in corporations happen frequently. For the most part, these conflicts occur as a natural part of business. The law provides a range of different rules dealing with conflicts and related party dealings and many corporations have developed extensive governance protocols to deal with the issue. In most situations where a problem arises it is not so much the nature of the conflict itself which constitutes the problem. Rather it is the way in which the conflict is handled by the executive or director involved or the board of the company affected.

Types of conflict of interest

There is a clear distinction between conflicts of interest which, in effect, happen *to* an executive or a director and those which are brought about *by* the actions of an executive or director. The common law rule against conflicts of interest is a natural incident of the fiduciary nature of a director's role. Essentially, it requires that a director avoids situations in which there is a real and sensible possibility of conflict between the director's personal interests and the corporation's interests.

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An executive who is not on the board is in the same position. The executive's contract of employment either explicitly or implicitly, will encompass an obligation that they are to avoid situations where their personal interests would be in conflict with the corporation's interests. Consistently, the *Coporations Law* imposes duties (with associated penalties for contravention) on directors and officers. This includes the requirement to exercise their powers and discharge their duties in good faith, not to improperly use their position to gain an advantage for themselves or to cause detriment to the corporation, and not to improperly use information obtained by virtue of their position to gain an advantage for themselves or to cause detriment to the corporation.

Change of control

So, how does this play out in a situation involving a potential change of control of a corporation? Every such situation entails a potential or actual conflict for executives. In any takeover, senior managers will have concerns about where they may sit if the takeover succeeds or fails. So an executive's position may significantly diverge from the position of a shareholder whose main concern is to maximise the value of their shareholding.

The extent of this conflict is exacerbated where, for example, the group making the takeover offer is contemplating enhanced rewards for particular executives if they agree to stay on after a successful takeover. Or where, in the classic leveraged or management buy-out, particular executives have a direct financial interest in the company making the takeover. There can be no more obvious position of conflict than when one is both the potential buyer of an asset and, at the same time, both managing the asset and being paid by those who have key responsibilities to shareholders in respect of the decision to sell. How can a person be trusted to work to maximise the sale price when they are also the potential buyer of the asset?

Before specifically considering the position of individual directors or executives in a change of control scenario, a little basic company law theory may assist. All the powers of a corporation initially reside with the shareholders. These powers are conferred by the shareholders on the board through the medium of the constitution of the corporation. This usually excludes certain specific powers which, by virtue of the Corporations Law or the particular constitution, can only be exercised by the shareholders in general meeting. Typically, the board will delegate its powers of management to the managing director. This delegation also is frequently subject to specific reserved powers, the nature of which will vary from corporation to corporation.

Shareholder control

Ultimately, control of the corporation is a matter for shareholders in the sense that, if sufficient numbers of shareholders do not sell their shares, there can be no change in control. However, the authority and power in relation to matters critical to the issue of control (for example, dealing with expressions of interest, soliciting bids, commissioning advice, and making recommendations about offers) are clearly part of the obligations conferred on the board by shareholders.

As a practical matter, in many situations, shareholders will never get the opportunity to deliver, or determine not to deliver, control to a potential offeror. This could occur, for example, if the target company board refuses to allow the potential offeror the opportunity to undertake due diligence, or refuses to agree to recommend an offer where the potential offeror has made the offer contingent on the target company board unanimously recommending the offer.

In contrast, the authority and power to deal with matters relevant to the control of the corporation are *not* part of the delegation to the managing director. These matters are exclusively reserved to the board. It follows that executives can only be involved in such matters to the extent specifically permitted by the board.

So where does all this place the individual players in a corporation which is the subject of a potential change in control? Every situation depends on its particular facts, but the following constitutes a summary of the rules. It is not rocket science.

Non Executive Directors/ Non Executive Chairman
Non-executive directors and non-executive chairmen must not place themselves in situations where their own financial position conflicts with their capacity to bring their independent judgment to the relevant issues in relation to a potential change of control. This applies in particular to protecting and enhancing shareholder value. For instance, without the properly informed consent of the board, it is unacceptable for non-executive directors and non-executive chairmen to take a financial position in the company making the takeover offer. To do so would generally constitute a breach of their duties as directors. While the position of all non-executive directors is the same, it is particularly obvious with the chairman. It is the chairman's duty to remain free to lead the board in the discharge of its responsibilities in relation to the change of control as this is a critical event in the life of a corporation.

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Managing director/executive directors
Unless they are acting with the fully informed consent and clear authority of the board and in accordance with the board's directions or protocols, executive directors have no independent right to take action in relation to issues affecting the control of their corporation. Thus, they would breach their duties as directors and officers of the corporation and their contracts of employment if:

- they engage in discussions with a company in relation to a potential bid for their corporation without the board of the corporation's knowledge and,
- entertain overtures from the company making the takeover offer in relation to their own financial position (eg becoming part of the buying group).

Other executives
Essentially, other executives of the corporation are in the same position as executive directors. In general, they should not enter into discussions of the type indicated above. Neither is it acceptable for an executive to assert that their involvement was with the specific knowledge or encouragement of the managing director, or other directors, where they were similarly improperly involved in such discussions with the company making the takeover offer.

In the context of change in control, it has been asserted that "management is entitled to seek the best returns for its labour". The fact that such an assertion might be seriously advanced is disturbing in the context of public concern over senior executive rewards in corporate Australia. Ultimately, however, the assertion is absurd. It necessarily implies that an executive is free to negotiate for him or herself the best financial outcome during a takeover offer, regardless of their duties at law and their obligations under contract. This is certainly not the case. Their willing agreement to work for a particular corporation necessarily entails their acceptance of the duties and responsibilities described in this paper. Moreover, their capacity to pursue unfettered their own financial interest is commensurately circumscribed. Where 'management' also occupies a position as a director of the corporation the absurdity of the assertion is further highlighted.

Whether a potential offeror should be allowed to engage in discussions with key executives of a target company about their future intentions if the offeror is successful in its bid is a matter for the board of the target company. Indeed, an offeror may well feel that part of the value it pays for a particular target is attributable to the target's management team. If that team departs after a successful takeover, there could be an immediate loss of value. It would be naïve to believe that such discussions between the offeror and existing management would never involve some dialogue concerning inducements to stay.

The point is that it is not management's right to decide to engage in such discussions. Whether an offeror should be allowed to engage in such discussions is a matter for the board of the target company. It may well be in shareholders' interests that the board permit this to occur if it perceived that this was key to shareholders receiving an attractive bid for their shares. For the target board, there are questions of when (if at all), under what agreement with the potential offeror and under what protocols (such as the presence of board members or advisors in discussions) the discussions take place. These questions can be quite exquisite, forming a potentially critical part of the board's strategy to obtain the best outcome for shareholders. ⓘ

Colin Galbraith AM FAICD is a national director of AICD. He is a special advisor to Gresham Partners Limited, chairman of BHP Billiton Community Trust, and a director of: Commonwealth Bank of Australia; OneSteel Ltd; and CARE Australia. He is also a trustee of the Royal Melbourne Hospital Neuroscience Foundation. Colin also has an advisory role for Allens Arthur Robinson where he was a partner from 1978 to 2006.