Directors' voting recommendations in schemes

Navigating the new landscape

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In any proposed scheme of arrangement to accomplish a friendly takeover, the target directors' public voting recommendations to shareholders are of central importance. Potentially complicating these recommendations is that one or more target directors are often eligible to receive some form of personal benefit if the scheme proceeds (in addition to the benefit they are entitled to receive under the scheme if they are also shareholders). A line of recent, conflicting cases suggests that disclosure alone of an additional contingent benefit may not be enough to allow a director to make a voting recommendation in schemes.

There is now uncertainty surrounding the ability of directors who stand to receive a contingent personal benefit to make voting recommendations in schemes and, if they do, the level of balancing disclosure required. In fact, there are now two diametrically opposing views in the Federal Court of Australia alone.

This article explores that uncertainty and offers practical guidance to navigate it.

Introduction

Friendly takeovers of ASX listed companies are now increasingly structured as a scheme of arrangement between the notional 'target' and its shareholders[1]. The acquirer and the target board are usually aligned in wanting to send a strong public message to shareholders that the proposed scheme has the unanimous support of the target board. That support is often evinced by the following public statements, both at the time the proposed scheme is first announced and then approximately six weeks to eight weeks later when the scheme booklet is sent to shareholders of the scheme company:

(a) a statement that the directors unanimously recommend that shareholders vote in favour of the scheme; and

(b) a statement that each director personally intends to vote in favour of the scheme for all shares they own or otherwise control.

These public statements of support are typically qualified as applying 'in the absence of a superior proposal' and 'subject to an independent expert opining (or continuing to opine) that the scheme is in the best interests of the shareholders'. Despite these well accepted qualifications, the directors' public statements of support are a central legal and commercial feature of these transactions.

In the context of takeover schemes, one or more directors of the target are often eligible to receive personal benefits if the scheme is approved and implemented (in addition to the benefit they are entitled to receive under the scheme if they are also shareholders). These additional personal benefits might include:

- a cash bonus if the scheme is implemented;
- the (partial) acceleration or waiver of vesting conditions attached to their performance rights and/or options;
- the (partial) forgiveness of a loan from the target company to the director on any accelerated vesting of their performance rights or options;
- ongoing remuneration arrangements following implementation of the scheme, either as an employee within the acquirer's group or under a consultancy arrangement; and
- in the case of a scheme where the consideration is or includes the acquirer's own listed scrip, a position on the board of the acquirer following implementation.

The target directors to whom these contingent additional personal benefits are offered are usually key executive employees; for example, a founder director who is the CEO or a long-standing executive director.

[1] For the financial year ended 30 June 2019, 72.2% of announced friendly takeovers valued at over $50 million were structured as a members' scheme of arrangements. Source: MinterEllison market analysis. This represents a slight increase from previous years..

The issue in a nutshell

Should the fact that one or more (executive) directors stand to receive the types of additional personal benefits described above if the scheme proceeds disqualify them from making a public recommendation to shareholders as to how they should vote on the scheme?

Until recently, the answer was a reasonably clear 'No'. Until recently, it was very much a matter for the director to personally consider whether the contingent benefit was sufficiently material to impugn their objective evaluation of the scheme. If the director considered that the contingent personal benefit they were eligible to receive (or any other factor) would create an actual or perceived material conflict of interest, the director would refrain from making a recommendation. Instead, the target board's evaluation of the proposed scheme including the directors' voting recommendation would be delegated to an independent board committee. If the director decided to make a recommendation, despite the potential to receive the additional personal benefit, all that was required was adequate disclosure of that benefit.

However, as a result of a line of recent cases, the position is no longer as clear-cut. In fact, there are now two diametrically opposing views in the Federal Court of Australia alone. Although some legal practitioners might be attracted by the prospect of testing the current uncertainties in court, most companies and their advisers involved in schemes seek maximum certainty. This article identifies the uncertainties and concludes by offering some practical guidance on how to navigate them.

What is the commercial rationale for these types of additional director benefits?

Offering a managing director or any other executive director of a target company a cash bonus subject to the scheme proceeding and to that executive remaining employed with the target as at the implementation date has a sound commercial basis. Particularly in an all-cash scheme where the acquirer is a larger industry participant (as opposed to a private equity acquirer), the managing director and other executive directors face the real prospect that their employment will promptly cease if the scheme is approved and implemented. That is because a trade buyer has its own management team and will be looking to achieve cost savings and other synergies at the management level. However, the timeframe from receipt of an initial non-binding indicative offer to implementation of a scheme can be six months or longer. That represents an extended period where the managing director or any other executive director could be heavily distracted and preoccupied about the security of their continuing employment with the target. They may naturally be inclined to search for, and ideally secure, a new job in the knowledge that if the scheme proceeds, their current employment may swiftly end. That distraction and uncertainty for the managing director or any other executive director is not conducive to the target running its business effectively, while the scheme process unfolds in the period of six months or more after the non-binding indicative offer is received.

Paying a cash bonus subject to the scheme proceeding and to the managing director or other executive director remaining employed with the target as at the implementation date (and often for a short period after that date) is a well-accepted mechanism to manage this risk. Such a payment provides a financial inducement for the director to not actively seek employment elsewhere (or to at least not commence a new role) during the scheme process but instead to focus on ensuring that it is 'business as usual' from an operational perspective during the extensive scheme period.

In terms of the (full or partial) accelerated vesting of options and performance rights, the commercial rationale for this is that if the scheme proceeds, the target will become a wholly subsidiary of the acquirer and delisted from ASX. This change of control event deprives the executives who hold these securities from the opportunity to achieve the relevant performance and/or time based hurdles attaching to their options and/or performance rights. Accelerated vesting is intended to compensate the executives for this, recognising that options and performance rights typically form an important overall component of executive remuneration.

The Disclosure-Based Framework

The disclosure requirements for a members' scheme of arrangement are set out in the Corporations Act and the regulations to that Act.[2] Those requirements include disclosure of any material interests directors have in the scheme in so far as those interests are different to the interests of shareholders. There is also express scope for a director to determine that it is appropriate for them to abstain from making a recommendation.

This disclosure based regime expressly anticipates and takes into account the possibility that directors may have a personal interest in a proposed scheme. Provided full disclosure is made, there is nothing within this statutory framework which prevents an interested director from making a recommendation.

The Previously Settled Position (in Victoria at least)

Until recently, this legislative framework has been considered a clear and reasonably well settled one – at least in Victoria. In 2017, the issue of director benefits in schemes arose squarely for consideration by the Supreme Court of Victoria in SMS Management & Technology Ltd.[3] In that case, the Court considered whether it was appropriate for the managing director of SMS to have provided a public voting recommendation in favour of a proposed scheme, circumstances where he was set to receive a $600,000 cash payment if the scheme was implemented. Robson J noted the disclosure based framework in the Act and observed that the scheme booklet disclosed the managing director's contingent cash incentive. His Honour concluded that the managing director's recommendation, accompanied as it was with an appropriate level of disclosure, was appropriate, stating that it was important for a managing director, who in this case was the 'main moving force behind the company', to give their reasons for recommending that shareholders vote in favour of the scheme.[4]

The reference by Robson J to the managing director of SMS being the *'main moving force behind the company'* is powerful and apt. It recognises that it is often the founder CEO or a long-standing executive director who best understands the scheme company's business, its upside opportunities and downside risks, and therefore whose views on the merits of the scheme most shareholders are vitally interested in hearing.

A vivid example illustrating how a managing director's well informed views on value and the overall merits of a proposed scheme might in fact *diverge* from other directors is in 2003 when the CEO of MIM Holdings, Vince Gauci, departed from his other six board members and recommended that shareholders vote *against* a scheme where Xstrata plc was offering $1.72 per share (that scheme was nevertheless approved and implemented). The broader point is that Robson J rightly acknowledges the commercial reality that it is often the managing director who has an intimate understanding of the target company and who is well placed to evaluate the overall adequacy of a scheme proposal. Any judicial overlay to the clear disclosure based framework in the Act and regulations that makes it *harder* for such a director to make a public voting recommendation should be approached with caution as being potentially disadvantageous to shareholders.

[2] Section 412(1) of the *Corporations Act 2001* (Cth), regulation 5.1.01 and Schedule 8 (Part 3) to the *Corporations Regulations 2001* (Cth)

[3] *Re SMS Management & Technology Ltd* [2017] VSC 257.

[4] Ibid [26].

A different approach: *Gazal* Corporation

The law surrounding the disclosure-based framework was recently considered in the Federal Court (New South Wales Division) case of *Gazal Corporation.*[5] The Court specifically considered the appropriateness of a managing director making a recommendation where they were set to receive a cash bonus of $1.7 million if the scheme was approved and implemented.

In *Gazal Corporation,* Farrell J disagreed with the approach taken by Robson J in *SMS Management & Technology.* Her Honour held that Gazal's managing director should have adopted what was stated to be the *'common practice'* of declining to make a recommendation, and he should have explained to shareholders that the reason behind this was because he would receive *'a substantial benefit'* dependent on the outcome of the scheme.[6] Farrell J further suggested that, as a general proposition, directors who stand to receive a bonus or benefit (other than as a shareholder) if a scheme succeeds *'should exercise caution in making a recommendation and, in my view generally should not do so'*.[7]

This has created some uncertainty, including her Honour's stated *'common practice'* of declining to make a recommendation in the circumstances described. Furthermore, her Honour's reference to *'a substantial benefit'* raises questions as to the precise boundaries of that disqualifying concept.

Farrell J also held that the question of whether it is appropriate for directors to make a voting recommendation should be considered at the time a scheme implementation agreement is entered into and the transaction publicly announced, *'with conditions crafted appropriately'*.[8] Farrell J proceeded to state that it was difficult for her Honour to see how the success of a scheme is prejudiced by a recommendation being made only by those directors who are not interested in the outcome of the scheme (disregarding for this purpose any interest a director has as a shareholder of the scheme company).[9].

In the final paragraph of her judgment, Farrell J issued a stern warning to scheme proponents, stating that they can no longer count on a scheme being approved if an interested director elects to make a recommendation.

A string of subsequent cases

It took only six days from the date the *Gazal Corporation* decision was published for the same issue to arise again for judicial consideration. This time, the issue arose in *Re Nzuri Copper,* in a matter heard before Vaughan J of the Supreme Court of Western Australia.[10] In that proposed scheme, two executive directors of Nzuri Copper were set to receive a cash bonus of $240,000 each if shareholders approved the scheme. Vaughan J ultimately approved the scheme at the second hearing despite the fact that the two interested directors had made a voting recommendation. That was on the basis of his Honour's assessment that the amounts involved were *'not out of the ordinary and within the scope of what might be considered commercially not unreasonable; ie one year's salary'*[11] and that the scheme booklet had made *'fulsome and prominent'* disclosure of the directors' interests.[12] It is submitted that this is the correct approach and one that is consistent with the disclosure-based framework in the Act and regulations. However, Vaughan J forewarned that in future, scheme proponents should *'take heed of'* the observations of Farrelll J in *Gazal Corporation.*[13]

One week later, this same issue was again ventilated, this time in the Federal Court of Australia (New South Wales division), and once more before Farrell J in

[5] *Gazal Corporation [2019] FCA 701*
[6] *Gazal Corporation* [2019] FCA 701, [30].
[7] Ibid.
[8] Ibid [32].
[9] Ibid [32].
[10] *Re Nzuri Copper Ltd; ex parte Nzuri Copper Ltd* [2019] WASC 189.
[11] Ibid at [87]
[12] Ibid [88] and .
[13] Ibid [89].

Ruralco Holdings Limited.[14] Under that proposed scheme, the managing director was entitled to cash payments of up to $2,460,375 under an incentive plan and a retention bonus if the scheme was implemented. Farrell J appeared to retreat from her earlier decision in *Gazal Corporation*, observing that it was for the managing director to decide whether to either make a recommendation or decline to do so and explain why.[15] Farrell J proceeded to note that it is for the Court to be satisfied that the disclosure in the scheme booklet is adequate and not misleading.[16]

Importantly, Farrell J in *Ruralco* specifically noted the prominent disclosure of the managing director's interests, with the disclosure appearing on every page of the scheme booklet where the directors' recommendations appeared (except for the cover page). Her Honour noted that this *'allows a shareholder to understand that there is an issue of what weight should be given to [the managing director's] recommendation'*.[17] Her Honour proceeded to caution that, *'The bare statement of the directors' recommendation (without reference to [the managing director's] interest) in other communications with shareholders, such as telephone canvassing, might be a circumstance which might lead a Court at the second hearing to decline to approve the scheme because the Court could not be assured of the integrity of the outcome of the shareholder vote'*.[18]

In *Ruralco,* Farrell J appears to have moderated her previously expressed view in *Gazal* by allowing the interested director to make a recommendation, on the basis that it was accompanied by full disclosure of the director's contingent personal benefit in all places throughout the scheme booklet that the directors' recommendations were referenced.

The issue returned across the Nullarbor one more time when the case of *Re Navitas Ltd* was heard before Vaughan J, again in the Supreme Court of Western Australia.[19] This was another case that concerned a 'retention payment' of $750,000 to an executive director. In *Re Navitas,* this payment was set to be accelerated if the proposed scheme was approved and implemented. The interested director in this case was one of six directors making a unanimous recommendation, and Vaughan J could not identify any reason why the interested director's recommendation (which was accompanied by proper disclosure) might have affected the integrity of the shareholder vote. Vaughan J noted that shareholders were likely to have given weight to the collective recommendation of the directors rather than the sole recommendation of the interested director.[20]

Vaughan J also took the opportunity to respond to Farrell J's earlier observation in *Gazal* that it is the *'common practice'* of interested directors to decline to make a recommendation. His Honour observed that this has not been the invariable practice in Western Australia, nor is it necessarily the practice in Victoria as shown by decisions such as *SMS Management & Technology.*[21] However, Vaughan J again cautioned that in future, practitioners should *'have regard to'* the observations of Farrell J in *Gazal Corporation.*[22]

The next case to consider this issue was *Re Spicers Limited,*[23]again in the Federal Court of Australia (Victorian division). That case concerned a scheme (with an interdependent capital return) to accomplish a friendly takeover of Spicers by a Japanese acquirer. In various places throughout the explanatory booklet, the directors expressed a unanimous recommendation that shareholders vote in favour of the scheme and the capital return, in the absence of a superior proposal and subject to the independent expert continuing to express the view that the scheme was in the best interests of shareholders. The booklet also disclosed that the Spicers Board had approved the payment of additional cash remuneration to the directors of Spicers conditional on the scheme becoming effective.

[14] *Ruralco Holdings Limited, in the matter of Ruralco Holdings Limited* [2019] FCA 878.
[15] Ibid [28].
[16] Ibid.
[17] Ibid.
[18] Ibid.
[19] *Re Navitas Ltd; ex parte Navitas Ltd* [No 2][2019] WASC 218.
[20] Ibid [37].
[21] Ibid [38].
[22] Ibid.
[23] Federal Court of Australia (Victoria), *Spicers Limited (No 2)* [2019] FCA 1110

Each of the four non-executive directors would receive additional cash remuneration of $170,000. The booklet disclosed that those amounts were to be paid in recognition of the directors' additional efforts in connection with delivering the transaction and having regard to the fact that their remuneration of $30,000 per annum since their appointment was substantially below market rates for non-executive directors of comparable ASX companies. Importantly for present purposes, the booklet also disclosed that if the scheme was not approved by shareholders and the Court, the additional payments would not be made.

After reviewing the recent cases, O'Bryan J observed:[24]

> *'With respect, I agree with the principles stated by Farrell J in each of Re Gazal and Re Ruralco. As her Honour observed in Re Gazal at [32]: "While it may be true that it has become a common practice for a bidder to require unanimous and unqualified recommendations from the directors of the target company, that "practice" does not justify the bidder and the directors of the target failing to address the circumstances of each individual case". Nevertheless, in the present case I am satisfied that there has been no lack of disclosure or unfairness to members by reason of the unanimous recommendation of the directors. That is for two reasons. First, there was adequate disclosure of the additional benefit to be received by the directors. Secondly, the additional benefit is not out of the ordinary and has a reasonable commercial basis; the additional payment to the directors is to supplement the fees payable to directors in circumstances where the existing fees received by the directors can be seen to be very modest.*

The latest case to consider this fluid issue is *Re Kidman Resources*,[25] also in the Federal Court of Australia (Victorian division). That case concerned a scheme for the acquisition of all of the ordinary shares in Kidman Resources Limited by a wholly-owned subsidiary of Wesfarmers. The scheme consideration was all cash. If the scheme succeeded, Kidman's managing director would receive a cash bonus incentive payment of $550,000, equating to one year's fixed annual remuneration. The managing director also held Kidman shares and performance rights, meaning that the $550,000 cash bonus would be in addition to the cash consideration he would receive under the scheme in his capacity as a shareholder. Full disclosure of this contingent cash bonus was made throughout the scheme booklet. In light of the preceding cases outlined in this article, Counsel for Kidman specifically raised the question of the role that directors should play in making a recommendation to shareholders who are to receive a substantial financial benefit if a scheme is approved.

Justice O'Callaghan made the following emphatic statements:26

> *"Counsel drew my attention to the decisions of Farrell J in Re Gazal Corporation Limited [2019] FCA 70, in particular at [29]-[32], and Re Ruralco Holdings Ltd [2019] FCA 878 at [26], which stand for the proposition that directors who are to receive a substantial financial benefit if a scheme is approved do and should as a general rule decline to make a recommendation to the shareholders as to how they should vote…For the reasons set out below, I respectfully disagree with her Honour's views set out above, and in particular in the highlighted parts of those passages. In my respectful view, the correct position is that explained by Robson J in Re SMS Management & Technology Ltd [2017] VSC 257."*
>
> *"It is apparent that of the universe of possibilities contemplated by those regulations as to when a director should make a recommendation to shareholders about a scheme, no reference is made to the circumstance that he or she may receive a substantial financial benefit if a scheme is approved. Given the comprehensive nature of those regulations, if such a fetter on the ability of a director to make a relevant recommendation to shareholders of that nature had been intended, one would expect it to be contained in terms in those regulations.*
>
> *In my view, shareholders, absent an explanation as to why any director is not "available", does not "desire" or is not "justified" in making a recommendation (reg 8301(a)), or "has not decided" whether he or she will vote in favour of or against the Scheme (reg 8302), would ordinarily expect directors to make such a recommendation, even when they may receive a substantial financial benefit. And in my view, the statutory and regulatory regime applicable ordinarily requires them to make a recommendation, one way or the other, whether they stand to gain if the scheme is approved or not."*

These are strident and cogent passages from O'Callaghan J. However, they are diametrically opposed to the views of another Federal Court judge – O'Farrell J.

[24] Ibid at 44
[25] [2019] FCA 1226, date of publication of reasons 7 August 2019
[26] Ibid at paras 104 to 117 of the judgement

So where to from here and what are the practical risks?

In light of these six recent and, in some cases, conflicting decisions, where does this leave us? Although the judicial position on this issue appears to have moderated since the high water mark of the *Gazal* decision and although the most recent case (*Re Kidman Resources*) expressly rejects the reasoning in *Re Gazal*, there still remains considerable uncertainty relating to whether or not an interested director in a scheme should make a voting recommendation at all and, if they elect to do so, the level of balancing disclosure required regarding the contingent personal benefit that the director stands to receive. The consequences of getting this wrong are potentially significant. For example:

- a Court may decline to make orders at the first Court hearing, on the basis that an interested director has already joined with the other directors in making a public recommendation at the time the scheme was first publicly announced and that director has then repeated that recommendation in the draft scheme booklet, in respect of which meeting orders are sought at the first Court hearing;
- if a director decides to make a recommendation but the balancing disclosure in the scheme booklet of that directors' contingent interest is regarded by the Court as inadequate, the Court may refuse to make orders at the first hearing, unless the balancing disclosure is amended to the Court's satisfaction – which may require an adjournment of the first hearing;
- ASIC may decline to give its usual preliminary no objection letter before the first Court hearing, refuse to register the scheme booklet after the first hearing or refuse to provide its final no-objection letter before the second Court hearing. If ASIC refuses to register the scheme booklet, the booklet cannot be released and the scheme would at that point be stopped firmly in its tracks. If ASIC registers the scheme booklet but refuses to provide its preliminary or final no objection letter, that introduces significant unwanted complications including the Court having to form a view on the tired section 411(17) issue of whether or not the scheme has been proposed for the purpose of avoiding the takeover provisions in Chapter 6 of the Act. Elevated evidence as to the absence of an anti-avoidance intention would need to be furnished. These are not fanciful or theoretical risks, especially in the short term. Given the diametrically opposed judicial positions in *Re Gazal* and *Re Kidman Resources*, ASIC may well decide that it is necessary for it to take a specific policy position on this issue. It is not outside the realm of possibility that ASIC could publicly express a preference for the views of Farrell J in *Re Gazal*;
- if shareholders approve the scheme, the Court may at the second hearing approximately one week later receive a formal objection from ASIC, an activist shareholder who voted against the scheme or from any other interested party, asserting that the Court should not approve the scheme because the relevant director should never have made a recommendation in the first place or, alternatively, the disclosure surrounding that director's contingent personal benefit was incomplete and/or insufficiently prominent – in these circumstances, the scheme company and the acquirer will need to expend significant time and resources to refute those grounds of objection, without any certainty of outcome. With increasing shareholder activism in public M&A transactions, it is very likely that this avenue of challenge will be taken in future schemes.

It should also be noted that similar complications to those noted above could manifest themselves in a friendly takeover structured as a conventional Chapter 6 takeover bid, given the similar disclosure based regime that applies to Target's Statements.[27] The principal difference is that the Takeovers Panel would be the forum where these matters are ventilated and tested.

Some Practical Guidance

Given the above real risks, what then are some practical measures to manage them? Set out below are some suggestions:

- At the earliest possible stage of a scheme transaction, each target director should consider with the benefit of professional advice whether any additional personal benefit they stand to receive if the scheme is successful is of such a magnitude that it should properly preclude that director from making a voting recommendation. This should be addressed during the negotiation of the scheme implementation agreement and before it is signed.

[27] Section 638 of the *Corporations Act* outlines similar disclosure requirements for a target's statement issued in response to a bidder's statement

- The target's board, without the relevant director present, should specifically consider whether or not it is appropriate for that director to make a recommendation on the Scheme despite the nature and quantum of the benefits which he or she will receive if the Scheme proceeds. As a guiding principle, the Board should consider the role that the director has played in the target's development, whether target shareholders *"would be legitimately expecting that director to express [his or her] views as to [the merits of] the scheme and would be surprised and disconcerted if [he or she] did not do so."* (per O'Callaghan J in *Re Kidman Resources at para 116(b)(i))).*
- As a general principle to guide the decision on this threshold issue, the value of the additional personal benefit must be kept within sensible limits and not be overly generous – as Vaughan J observed in *Re Nzuri* , it should *'be not out of the ordinary and within the scope of what might be considered commercially not unreasonable; ie one year's salary'*.
- If the additional personal benefits arise under pre-existing executive employment contracts that were entered into well before the recent decisions referred to in this article, those arrangements should be revisited to reassess whether the nature and value of the benefits satisfy the above principle of being commercially reasonable.
- A specific clause should be drafted into the scheme implementation agreement that modifies the usual 'unanimous' director recommendation obligation by expressly preserving the flexibility of a target company's director to not make a recommendation (or to not continue to maintain a recommendation) if he or she determines at any point in the scheme process that their interest in the scheme is so materially different from other shareholders that they are precluded from providing (or continuing to provide) their recommendation. This saving clause should be expressed as operating despite any other provision of the scheme implementation agreement.[28] This then has the practical effect of negating the termination and break fee provisions which are typically expressed to be triggered if 'any' director changes or withdraws their recommendation or if there is not unanimity in the directors' recommendation or if that unanimity ceases at any point.

  Admittedly, it would appear incongruous for an initial announcement to state that the target directors 'unanimously' recommend that shareholders vote in favour of the scheme, only for the scheme booklet to subsequently state approximately six to eight weeks later that just the 'independent directors' recommend voting in favour of the scheme. This inconsistency of approach between initial public announcement and the release of the scheme booklet may be seized on by any one or more of ASIC, an activist shareholder, a competing bidder or ultimately, the Court. The question may be asked as to what has changed between initial announcement (where there was a unanimous recommendation from all target directors) and the subsequent release of the scheme booklet (where some directors are abstaining from making a recommendation) and, in turn, why the matters causing a divergence from that earlier unanimity were not identified and addressed before the initial public announcement.
- Prominent disclosure must be given of the contingent additional personal benefit, as this will allow shareholders to assess what weight should be given to the relevant director's recommendation. It is suggested that prominent disclosure is best achieved as follows:
  - In the Chairman's letter of the scheme booklet, as this is a key early part of the booklet that most shareholders are likely to read. This approach was taken in the recent Nippon Pain/Dulux scheme where the Chairman's letter referenced that the CEO of Dulux and another executive director (who was also the CFO) would, if the scheme is implemented, become entitled to early vesting of unvested performance rights and forgiveness of 30% of the original amount of the associated loans. This disclosure should be made in the body of the Chairman's letter itself, not in a footnote to the letter (as occurred in the SMS scheme).
  - In the 'Frequently asked questions' section of the scheme booklet, the summary of the scheme section and in the core section on advantages and disadvantages of the scheme.
  - In the additional information section.
  - If, as is usually the case, an offer information line is included for inbound shareholder queries and/or an outbound shareholder canvassing campaign is undertaken, the script used for such telephone

[28] See for example clause 7.2 of the scheme implementation agreement in the Creso Pharma/PharmaCielo scheme, released to ASX by Creso Pharma Limited on 7 June 2019. MinterEllison advised PharmaCielo in that transaction.

discussions should, whenever referring to the directors' voting recommendation, expressly note the personal additional benefit that the relevant director(s) stands to receive if the scheme proceeds.

More generally, any form of shareholder canvassing or communication that is undertaken during the one month scheme notice period must be carefully constructed so that contingent director benefits are appropriately disclosed. Any failure to do so carries the risk that the Court may conclude at the second approval hearing that the integrity of the shareholder vote in favour of the scheme has been compromised by adjacent shareholder canvassing or other communications that did not align with the level of disclosure in the scheme booklet.

Conclusion

With the continuing popularity of schemes to accomplish friendly takeovers, there is little doubt that the jurisprudence on contingent director benefits in schemes will continue to evolve. Subsequent cases should, it is submitted, follow the *Re SMS* and *Re Kidman Resources* approach of facilitating rather than discouraging or unduly constraining the ability of target directors (especially executive directors) to make a voting recommendation even if they stand to receive a personal benefit if the scheme succeeds. Shareholders often attach considerable weight to the public voting recommendation of executive directors, as it is these directors who have an intimate understanding of the target's business, its strengths, weaknesses, opportunities and risks in the broader industry setting within which the target operates. Shareholders in turn implicitly expect that the voting recommendations of executive directors embody a well-informed evaluation of the adequacy of the offer price, the level of conditionality and the overall terms of the proposed scheme.

To deprive shareholders altogether of that recommendation or to place overly onerous legal hurdles on the ability of executive directors to make a voting recommendation is detrimental to shareholders' fully informed assessment of the scheme. It is not a complete answer to say (as Farrell J suggests in Gazal) that these interested directors remain free to state how they intend to vote in respect of their own shares.

Equally, it would be a welcome development if the subsequent cases continue to reinforce the importance of setting the quantum of contingent benefits for executive directors in schemes within commercially reasonable limits. In the case of cash bonus payments, the quantum should strike a sensible balance between, on the one hand, providing a retention effect during the uncertainty of a control transaction that could result in loss of employment for executive directors following implementation and, on the other hand, not providing a windfall gain. A similar balancing approach should be taken with respect to the Board's determination on the appropriate level of acceleration or waiver of vesting conditions attached to executive directors' performance rights and/or options, and similarly the extent of any loan forgiveness arrangements.

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