



Hong Kong

July 2019

SFC REMINDS LISTED COMPANIES OF DUTIES ON CORPORATE ACQUISITIONS AND DISPOSALS

Introduction

The Securities and Futures Commission (**SFC**) issued a reminder to the directors of HKEx-listed companies and their advisers of their statutory and legal duties when evaluating and approving corporate/business acquisitions and disposals in its Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals¹, published on 4 July 2019. The SFC statement describes common forms of misconduct seen on corporate acquisitions and disposals, noting that 55% of the letters of concern issued to over 46 listed companies in 2017 and 2018 related to proposed corporate acquisitions or disposals.

Over the past two years, the SFC has adopted what it calls “front-loaded regulation” using its investigative powers under the Securities and Futures Ordinance, and its powers to object to a listing or suspend trading in a listed company’s securities under the Securities and Futures (Stock Market) Listing Rules, to intervene early in serious cases of misconduct. It publishes regular bulletins highlighting cases of its intervention, most recently in February 2019. The SFC’s February 2019 Regulatory Bulletin² on listed corporations gives the following examples of proposed transactions where it will typically intervene:

- Transactions that appear to the SFC to be oppressive or unfairly prejudicial to a listed company’s shareholders or potential investors;
- Transactions involving fraud or serious misconduct towards a listed company, its shareholders or potential investors; and
- Transactions where the shareholders or potential investors are not given all the information regarding the listed company’s business or affairs that they might reasonably expect.

Listed company directors have duties to act in good faith in the company’s best interests and to exercise due and reasonable care and skill in evaluating, proposing and approving corporate transactions. The SFC’s latest statement should be read in conjunction with its Guidance Note on Directors’ Duties in the Context of Valuations in Corporate Transactions³ and Circular to Financial Advisers in relation to their Advisory Work on Valuations in Corporate Transactions⁴.

Types of Misconduct

The SFC’s July statement gives eight examples of common misconduct in corporate acquisitions and disposals.

1 <https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-the-conduct-and-duties-of-directors.html>

2 [https://www.sfc.hk/web/EN/files/ER/PDF/SFC_Regulatory_Bulletin/SFC_Regulatory_Bulletin_Listed_Corporations_\(Feb_2019\)Eng.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/SFC_Regulatory_Bulletin/SFC_Regulatory_Bulletin_Listed_Corporations_(Feb_2019)Eng.pdf)

3 <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidance-note-on-directors'-duties-in-the-context-of-valuations-in-corporate-transactions/guidance-note-on-directors'-duties-in-the-context-of-valuations-in-corporate-transactions.pdf>

4 <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=17EC25>

1. Failure to Obtain Independent Professional Valuation

There is no express statutory or HKEx Listing Rule requirement for listed company directors to obtain an independent professional valuation for a company or business the subject of a proposed acquisition or disposal. Nevertheless, failure to obtain such a valuation is likely to constitute a breach of listed company directors' duty to exercise the degree of care, skill and diligence reasonably expected of them in acting in the best interests of the company and its shareholders.

The SFC notes that many listed issuers which do not engage independent professional valuers make announcements which fail to give shareholders the information regarding the target business that they would expect. These issuers often issue fairly simple announcements stating that the consideration was agreed after arm's length negotiations on the basis of vaguely described matters (e.g. the target's leading industry position).

2. Failure to Exercise Independent Judgment and Accountability

The SFC also criticised directors who relied on valuation reports that did not provide a credible basis for assessing a proposed acquisition. Particular deficiencies in valuation reports included:

- Valuers often relied simply on vendors' forecasts and failed to conduct any due diligence or other assessments of those forecasts;
- Profit forecasts were often unsubstantiated, and at times, merely replicated profit guarantees provided by the vendors. In many cases, valuers merely applied a profit forecast or guarantee to a multiple derived from a number of supposedly comparable companies "cherry-picked" to support a pre-determined estimate of the target business;
- Some valuers disclaimed all liability for the reliability of the projections.

The SFC statement notes that it would be highly imprudent for directors to base decisions on corporate acquisitions or disposals on defective valuation reports of this type. It also reminds listed companies that contrivance between directors, as corporate insiders, and the valuer to use the valuation report

as a means to provide artificial justification for a predetermined price estimate could amount to fraud on the listed company's shareholders.

3. Quality of Earnings

Directors are reminded to perform independent due diligence on the forecasts, assumptions, or business plans provided by the target's vendors or management, if these are the basis for the acquisition price. Directors should also pay attention to the quality of the target business' earnings and the presence of apparent risk factors such as historical losses, sudden and unexplained increases in sales, and unjustifiably high margins compared to industry peers etc. Suspect non-recurring items and questionable or unsustainable revenue sources are other red flags that should be investigated. The SFC statement gives as an example significant acquisition premiums paid by issuers to enter a new industry with low entry barriers without clarifying why the company did not simply start the same businesses itself to avoid the acquisition premium.

4. Fair Presentation of Comparables

Where valuation is performed based on the multiples of other publicly traded companies, the SFC stresses the importance of selecting appropriate comparable companies. The SFC statement notes that valuers and company directors must choose companies with similar characteristics to the target, and must ensure that comparables referred to in the valuation are a fair and representative sample.

The valuation report should clearly state the bases for compiling any comparables and these must be justifiable. Directors should avoid "cherry-picking" companies with higher trading multiples while ignoring those with poorer performance, or choosing companies with significantly longer and more profitable track records than the target, without making adjustments to account for differences between comparison companies and the target.

5. Impact on Financial Position

The SFC statement notes that directors sometimes fail to assess the negative impact a proposed acquisition may have on the listed company's resources and financial position. Listed companies' financial position will typically be affected by the need for additional funds to finance the acquisition and to provide the capital needed by the target to meet the vendor's forecasts. In some cases, the SFC has found that directors

fail to consider the capital expenditure required to sustain the target's business, the method of funding that expenditure, and its impact on the listed company's financial position.

6. Compensation

Many listed issuers pay consideration up-front based on a profit forecast prepared by the vendor and an undertaking by the vendor to compensate the issuer if the projected profits are not met. However, there is often no verification of the vendor's ability to pay or other steps to protect the listed issuer, such as the holding of funds in escrow. The maximum potential compensation payable is also sometimes significantly lower than the amount of consideration payable by the issuer, notwithstanding that the consideration is calculated by reference to vendor's profit guarantee.

7. Suspicious Connected Parties

The SFC statement notes that certain transactions suggest the existence of an undisclosed relationship or arrangement between purportedly independent third parties. While these parties may be outside the HKEx Listing Rules' definitions of 'connected persons' or 'connected transactions', they may still be subject to enforcement action (e.g. under the Securities and Futures Ordinance), if their undisclosed relationships, arrangements or understandings cause them to act in a manner detrimental to the listed issuer and its shareholders, or distort the market for its shares.

The following two examples of suspicious transactions are given:

1. A listed company sells the target shortly before the profit guarantee period ends, when it seems likely that the target's profit will not meet the forecast. The transaction is suspicious because the amount the listed company would recover under the profit guarantee is larger than the proceeds of the disposal. In addition to concerns regarding the listed issuer's conduct of its business and the directors' performance of their duties, the disposal also raises concerns as to a possible undisclosed relationship or arrangement between the purported independent third party buyer and the connected vendor.
2. A target company acquired by a listed company which recorded a significant boost in sales growth attributable to a small number of customers over a short period of time, thereby inflating the valuation of the target.

Investigations revealed that the fees and income received by the target came from parties associated with the listed issuer's directors.

8. Proper Investigation and Due Diligence

Directors must ensure that any forecast or estimation used in relation to a planned corporate acquisition or disposal is compiled with due care, and that the underlying assumptions are fair, reasonable and representative of company management's best judgment or estimates at the time. In adopting or approving any forecast or estimation, directors are required to:

- a) properly understand the implications of the underlying assumptions;
- b) ensure that the main uncertainties are reflected appropriately; and
- c) ensure that assumptions are described specifically.

While the appointment of a financial adviser to advise the board is not required by law or by the HKEx Listing Rules, a failure to do so might constitute misconduct if the directors collectively do not have sufficient time, resources and expertise to perform the necessary work without the assistance of a financial adviser.

A financial adviser is required to conduct its own independent assessment of, and perform reasonableness checks on:

- a) the forecasts, assumptions, qualifications and methodologies of the valuation; and
- b) (where applicable) the directors' decision not to appoint a professional valuer.

Where a valuer is appointed, the financial adviser should also satisfy itself that the directors have considered:

- a) the valuer's professional qualifications and relevant experience;
- b) the scope of the mandate; and
- c) the reasonableness of the forecasts, assumptions, qualifications and methodologies used in the valuation.

The SFC statement also points out that obtaining an independent professional valuation does not absolve, reduce or modify the statutory duties of care, skill and diligence, or the fiduciary duties owed by the directors. Directors are still required to exercise due and reasonable care, skill and diligence in discharging their duties. If guidance is required, directors could refer to the SFC's guidance published on 15 May 2017 regarding directors' duties in the context of valuation in corporate transactions.

Consequence of misconduct

If the SFC suspects that an announced corporate acquisition or disposal involves misconduct in breach of the Securities and Futures Ordinance or other applicable laws, it will use its powers under that Ordinance and under the Securities and Futures (Stock Market Listing) Rules to investigate, and potentially prosecute, that misconduct.

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