The SFC's Guidance on Valuations in Corporate Transactions:

What Listed Companies and Their Directors Should Know

June 2017

The Securities and Futures Commission (**SFC**) recently issued: (i) a guidance note on directors' duties (**Guidance Note**); (ii) a circular to financial advisers (**Circular**); and (iii) a statement on the liability of valuers, in the context of valuations in listed companies' corporate transactions.

What this note highlights

This note highlights the key implications of the guidance from the perspective of Hong Kong listed companies and their directors. We have prepared a separate note on the impact of the guidance on financial advisers who are appointed to assist with listed companies' corporate transactions.

Key implications for listed companies and their directors

- Directors must conduct proper due diligence on the assets / target company and appraisal of the consideration.

  This includes taking all reasonable steps to verify the accuracy and reasonableness of material information likely to affect valuation and not blindly accepting the financial forecasts or assumptions provided by another party.

- Directors should consider, in light of the particular transaction, the need to appoint a professional valuer to advise on valuation and/or other adviser (such as a financial adviser (**FA**)) to assist with the transaction.

  We expect the guidance may well increase the instances of such appointments. However, directors should still cast a critical eye over any external advice and only rely on it to the extent it is reasonable in the circumstances.

- If a professional valuer is appointed, directors must consider its scope of mandate and ensure it is such that the valuation report will be relevant and useful in helping directors to determine an appropriate price.

  Directors should therefore be satisfied that the valuer's mandate is not based on or subject to such wide assumptions or qualifications that directors can no longer reasonably rely on the valuation report in their decision making.

1. When is the Guidance Note relevant?

The Guidance Note is relevant whenever a Hong Kong listed company is considering a transaction which involves the sale or purchase of assets, shares or a business (**Corporate Transaction**).

2. Why has the SFC issued the Guidance Note and why is it targeted at directors?

The SFC is concerned by instances where listed companies have acquired assets or target companies at unreasonably high prices or sold them at a substantial undervalue, and valuations were either not obtained in these transactions (when circumstances suggest it would have been appropriate to do so) or were relied upon to justify the transaction when such reliance was imprudent.

The Guidance Note is targeted at directors as they are the guardians of a listed company's assets. Listed company directors are subject to directors' duties under law, regulations, codes and rules such as the Hong Kong Listing Rules (the **Listing Rules**) to act in good faith in the interests of the company and to exercise due care, skill and diligence in discharging their duties.

In the context of a Corporate Transaction, this means directors are responsible for determining whether the proposed transaction is in the interests of the company and its shareholders as a whole, and whether the consideration to be paid is fair and reasonable. Directors must therefore conduct proper due diligence on the relevant assets or target company and proper appraisal of its worth (such duties are described in more detail below).

3. What steps should directors take on a Corporate Transaction?

<u>Conduct proper diligence to assess the merits of the deal and the valuation</u>

As noted above, it is part of the duties imposed on directors to conduct proper investigation and due diligence on the relevant assets or target company and appraisal of its worth prior to entering into a Corporate Transaction.

The Guidance Note sets out the SFC's expectations of the diligence to be performed by directors in this context. Broadly, they include:

(i) understanding the nature of the assets or business;

(ii) carefully considering information relevant to assessing the merits of the proposed transaction;

(iii) taking all reasonable steps to verify the accuracy and reasonableness of material information that is likely to affect valuation of the assets/ target company, and seek further information from the seller as appropriate. In particular, this means directors should be satisfied that the financial forecasts, assumptions and business plans provided are reasonably justified (in light of relevant factors such as the target's financial status, historical performance and peer companies) and not unquestioningly accept such forecasts and assumptions;

(iv) seeking assistance from professional valuers or other advisers if appropriate; and

(v) paying closer attention when certain "risk factors" are present. For example, where: (a) the target is a new business, generates little profit or has minimal net assets; (b) the valuations are based on forecasts with no historical basis; (c) the forecasts assume aggressive growth; (d) the target has entered into new or non-binding contracts which are then used as a basis for sales projections; and (e) recent transfers of shares of the target place it at lower valuations than the amount the listed company is being asked to pay (or vice versa for a disposal).

<u>Consider the need to appoint a professional valuer or other adviser</u>

Directors are expected to consider the need for a valuation by a professional valuer. Relevant factors in the decision on whether to appoint a valuer include: (i) whether the directors possess sufficient experience or expertise in the field of the proposed investment or in valuation; (ii) whether the target is in its infancy or the information requires professional advice in order to properly assess the merits of the deal; (iii) the size, significance, risks, complexity and nature of the transaction; and (iv) whether any director has an actual or potential conflict of interest in the proposed transaction.

Directors should be prepared to justify why they have not appointed a valuer, taking into account the factors above.

The appointment of an FA is not required under the Listing Rules for all Corporate Transactions. The Listing Rules only require listed companies to appoint an FA on certain transactions. However, where an FA is appointed on a Corporate Transaction (whether or not it is required under the Listing Rules), the Circular now expects FAs to act as a key part of the valuation "verification" exercise.

<u>Consider the suitability and scope of work of an external adviser</u>

Where a valuer is appointed, the Guidance Note requires directors to assess the valuer's: (i) independence and conflicts of interest; (ii) qualification and reputation; and (iii) relevant expertise and resources. The Guidance Note also expects directors to be involved in considering the scope of a valuer's mandate to ensure the valuation report will be relevant and useful in aiding the directors to determine a fair and reasonable price and allow the directors to reasonably rely on the valuation in their decision making. It will not normally be acceptable for a valuation to be conducted on the assumption that the vendor's projections or forecasts will be met.

If an FA is appointed, directors must pay attention to the scope of an FA's mandate and draft it (in consultation with the FA) appropriately for the matter in question. Where a listed company has appointed both a valuer and an FA, directors should in particular ensure the FA's mandate encompasses the FA complying with its obligations under paragraph 5.3(a) and (where applicable) paragraph 5.3(b) of the SFC's Corporate Finance Adviser Code of Conduct. Broadly speaking, these code provisions oblige the FA to assess the experience and expertise of the valuer and, unless it is a property valuer, the reasonableness of the bases and assumptions adopted by the valuer. Where a listed company appoints an FA but not a professional valuer, the Circular requires FAs to be satisfied that both the decision not to appoint a valuer and the valuation prepared (by the listed company or a non-valuer third party) have been made on a reasonable basis.

The above represents a move away from market practice as FAs may otherwise exclude valuation issues from its mandate.

<u>Remaining involved and engaged even if an external adviser is appointed</u>

Directors cannot abdicate their responsibilities by using valuers or other advisers as a shield and should not place unquestioning reliance on external advice. Directors are expected to remain engaged, read the actual valuation report, and cast a critical eye over the basis of computation, scope of review, assumptions and valuation methodologies on which a valuation is based. Directors should be particularly involved where the risks or materiality of the transaction call for it.

4. What are the potential consequences of breaching the Guidance Note?

The SFC may bring court proceedings against (current or former) directors under section 214 of the Securities and Futures Ordinance for breach of directors' duties that have resulted in loss to the listed company or its subsidiaries. This may result in, for example, disqualification orders or compensation orders against directors to compensate the listed company for the loss.

The SFC will take into account whether directors have complied with the Guidance Note when assessing a breach of directors' duties and is more likely to seek orders against directors who do not act in accordance with the Guidance Note.

It should also be noted that a listed company's officers and/or appointed valuer may fall foul of market misconduct provisions under the Securities and Futures Ordinance if it is found that there has been a disclosure of false or misleading information in a corporate disclosure document, and the party knew (or were reckless or negligent as to whether) the information is false or misleading as to a material fact or a material fact was omitted. Therefore, in the context of a Corporate Transaction, directors should carefully assess whether an accurate and non-misleading picture of the target / assets has been portrayed in corporate disclosure documents taking into account what they know from the due diligence and valuation exercises.

Peter Brien
T +852 2901 7206
E peter.brien@slaughterandmay.com