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## Shareholders' Protection Through the Enhanced Independent Advice Circular

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### Abstract

Shareholders of a target company must be well informed of the merits of a takeover bid for their shares. The takeovers law requires the board of the bidder to provide all information necessary to enable the shareholders of the target to arrive at an informed decision. In addition, the board of the target company is also required to appoint an independent adviser to assist the shareholders in making their decision. The Securities Commission Malaysia (SC) has published a consultation paper in March 2010 with the aim of improving the quality of independent advice circulars. The SC suggests that when arriving at its opinion, an independent adviser should see that the takeover bid is "fair" and "reasonable". The SC chooses to adopt the Australian approach which decouples the terms "fair and reasonable". This article examines the criteria which are laid down by the SC for an offer to be "fair" and "reasonable". It also examines the contents of independent advice circulars in Malaysia and their usefulness to the shareholders when assessing the merits of the bid.

### Introduction

Shareholders of a company enjoy many benefits during the good days of the company's life. When the company becomes a target of a takeover, the shareholders are placed in a quandary to decide whether to remain in the company or exit the company. They generally look forward to getting the best value for their shares before they decide to give up their shares. Shareholders in a public listed company may easily refer to the market price to determine the minimum price for their shares. However, for a non-listed company, the shareholders will have to exert more efforts to determine the value for their shares. Thus disclosure of information is a very significant factor in determining the right value for the shares and assists shareholders, in a takeover, to make an informed decision when deciding to sell their shares to a bidder. A valuation

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of the company and its assets by a professional will assist in determining the right value for the shares.

The Malaysian takeovers and mergers law seeks to protect the shareholders of the target company. In view of this, the Malaysian Code on Take-overs and Mergers 1998 (hereinafter referred to as “the Code”) was formulated to ensure that the acquisition of control over a company takes place in an efficient, competitive and informed market.<sup>1</sup> It also aims at ensuring that all the shareholders affected by a takeover are given reasonable and equal opportunity to participate in any benefits accruing to the holders.<sup>2</sup> The law applies to all public companies whether listed or unlisted. In order to ensure that the target shareholders arrive at an informed decision, the Code requires the board of the target company to appoint an independent adviser upon whom an obligation is imposed to prepare a report in order to provide all such information as is necessary in relation to the takeover.

In March 2010, the Securities Commission (hereinafter referred to as “the Commission”) proposed a review of the content of independent advice circulars (hereinafter referred to as “IACs”) to enhance the quality of advice circulars and reliability by target shareholders upon such advice. The review arises from the Commission’s concern with the quality of information in the IACs with a view to enhancing the protection for shareholders.<sup>3</sup> The Commission published a public consultation paper where it proposes to decouple the phrase “fair and reasonable” when evaluating takeover offers with a view to improving the standard measurement that advisers use.<sup>4</sup> It is worth noting that despite the fact that the Code requires the adviser to evaluate on the “reasonableness” of an offer, in practice advisers have prepared their advice on the basis of evaluating whether the offer is “fair and reasonable”.<sup>5</sup> The phrase “fair and reasonable” in relation to a takeover offer has never been defined in Malaysia. Thus the Commission seeks to ensure that independent advisers, when stating whether the offer is “fair and reasonable”, undertake “sufficient analysis and synthesis in reaching to such conclusion”.<sup>6</sup>

The aim of this paper is to examine the move by the Commission to decouple the term “fair and reasonable” when assessing the takeover offer. In view of this, the author carried out a study on the IACs from the year 2009 up to

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1 Capital Markets and Services Act 2007, s 217(5).

2 Ibid.

3 Securities Commission Malaysia, “Proposed updates to guidelines on offer documentation of the Malaysian Code on Take-overs and Mergers 1998, Public consultation paper No 2/2010 (March 19, 2010), available online at [http://www.sc.com.my/eng/html/consultation/CP\\_02\\_2010\\_IAC\\_Guidelines.pdf](http://www.sc.com.my/eng/html/consultation/CP_02_2010_IAC_Guidelines.pdf), p 3, para 1.6.

4 Ibid.

5 Schedule 2(1)(e) to the Code states that the IAC, when recommending acceptance or rejection of the takeover offer, must contain comments and advice on the reasonableness of the takeover offer.

6 Public Consultation Paper, No 2/2010, supra, n 3, at p 2.

June 2010. This paper discusses the inconsistencies in the IACs. It further analyses how the IACs can be enhanced by treating “fairness” and “reasonableness” as two different concepts and whether such an approach will reduce the inconsistencies in the IACs and improve their quality. Since the Commission’s approach reflects the adoption of the “fair” and “reasonable” definition in line with the Australian practice, the author will make reference to the Australian guidelines on the expert report to shed some light onto the discussion.

### **What is Independent Advice Circular (IAC)?**

The expert report, more commonly known as the independent advice circular in Malaysia is a report specially prepared by an independent adviser or expert in assisting the shareholders of the target to make their decision as to whether to accept or reject a takeover bid. Thus, the independent advice circular becomes relevant in all types of takeover offers; be it a voluntary or mandatory offer. It must also be noted that in cases of reverse takeovers, the board of the bidder is under an obligation to obtain independent advice for their shareholders. The reason being that in a reverse takeover, the control would pass from the bidder to the target company. It is worth noting that where the bidder revises its offer, the Commission may require the independent adviser to produce a supplementary independent advice letter. This advice letter is commonly required where there has been a significant change in the content of the IAC sent earlier.

In Malaysia, an independent advice letter is also required in cases involving schemes of arrangement and selective capital reduction.

### **When is an independent advice circular required?**

In line with the aim of the takeovers law which seeks to ensure that takeovers take place in an efficient and informed market, the law imposes an obligation upon the board of the target to provide their shareholders with adequate information to enable the shareholders to make an informed decision. Section 15 of the Code requires the board of the target to appoint an independent adviser in relation to a takeover offer as soon as after it becomes aware of the possibility that a takeover offer may be made.<sup>7</sup> The independent adviser’s view on the offer must then be made known to the holders of voting shares in the target through a circular. An independent advice circular thus seeks to assist the shareholders of the target in determining the real value of their shares and assist the board of the target in determining whether or not to recommend a takeover offer. In a reverse takeover, the board of the bidder is required to obtain independent advice and the circular must be circulated to its shareholders.<sup>8</sup> Similarly, where the bidder is faced with a conflict of interest

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<sup>7</sup> See the Code, s 15(1) and PN 4.2.

<sup>8</sup> The Code, s 15(4).

situation, for instance where there are significant cross-shareholdings between a bidder and the target company or where there are a number of directors common to both companies, the law requires the bidder to obtain an IAC.<sup>9</sup> Prior consent must be obtained from the Commission before the board of the target can send the IAC to its shareholders.<sup>10</sup> This is to ensure that the IAC complies with the requirements of the Code and the guidelines as required by the Commission. The IAC must be posted to the relevant holders of voting rights within 10 days from the date the offer document is posted, the same day on which the board of the target must give its comment to the holders of the securities on whether to accept or reject the offer.

The holders of the securities would be more likely to accept the offer where the price offered by the bidder reflects a value higher than the market value for the securities. It is worth noting that where the target is a listed company and the offer is a mandatory offer, it is much easier to assess the offer price since the minimum price as determined by the Code is the highest price paid for the shares by the bidder during six months prior to the making of the offer.<sup>11</sup> Similarly, in a voluntary offer where a bidder has purchased 10% or more of the shares of the target company six months prior to the takeover offer and paid the consideration in cash, the Code imposes the minimum price for the shares in the target to be the highest price paid for the shares by the bidder during six months prior to the making of the bid.<sup>12</sup> However, in a voluntary offer which does not involve the situation mentioned earlier and where the company's shares are not listed, careful attention must be given in order to see whether the offer is fair and reasonable.

### **Who is an independent adviser?**

Section 217(1) of the Capital Markets and Services Act 2007 defines an expert to include an engineer, valuer, accountant and any person whose profession gives authority to a statement made by him. This definition is further elaborated in Practice Note (PN) 1.3 to the court where an adviser is referred to as a person who has the necessary expertise and experience in corporate matters.<sup>13</sup> Prior to the appointment of the adviser, the board of the target must obtain approval from the Commission.<sup>14</sup> The Commission will examine the independence of the adviser proposed by the company before approving such appointment. An independent adviser should strive to provide objective and clear advice which would enable shareholders to exercise their judgment. In carrying out

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9 The Code, s 15(2). The above instances which relates to conflict of interest is explained in notes on Rule 3.2, The Code.

10 The Code, s 15(6). The approval however does not indicate the Commission agrees with the recommendation made by the independent adviser. See s 15(6A).

11 The Code, s 20.

12 The Code, s 21(1).

13 PN 3.1 (1).

14 The Code, s 15(8).

its task, the adviser must adhere to the relevant laws to avoid any negligence or false or misleading information.<sup>15</sup>

### **The supervisory role of the Commission in the appointment of an independent adviser**

The Commission plays a significant role in approving the appointment of an independent adviser to ensure that the adviser to be appointed is able to undertake its tasks in providing independent advice. The importance to observe high standards by those who prepare the expert report can be observed in *Phosphate Co-operative Co of Australia Ltd v Shears (No 3)*<sup>16</sup> where Brooking J said:

Unless high standards are observed by those who prepare those reports, there is a danger that systems established for the protection of investing public will, in fact, operate through their detriment through reliance placed on these reports and on the reputations of those who furnish them.

In the appointment process, the Commission is guided by PN 4.3 as discussed below. Prior consultation in relation to the preparation of the IAC with the Commission is very important. The advisers are required to communicate with the Commission in writing all matters which they seek to discuss prior to the consultation. The advisers must clearly define the issues on which they seek the advice of the Commission and be thoroughly familiar with the issues relating to the obligation under Part II of the Code and be able to provide their views on the issues referred to the Commission.<sup>17</sup> The Commission will scrutinise the content of the IAC to ensure compliance with the guidelines and the Code.

### **Disqualified advisers**

The Commission will not regard as an appropriate and independent adviser a person who has an interest in 10% or more of the voting shares in the bidder or the target during the offer period or during the preceding last 12 months.<sup>18</sup> The Practice Note requires the adviser to have a sufficient degree of independence from the bidder and the target from any situation that can create a conflict of interest to ensure that the advice given is properly objective.<sup>19</sup> Accordingly, where the adviser has a significant interest in or financial connection with either the bidder or the target, it would be presumed that the adviser lacks independency.<sup>20</sup> Similarly, where there is cross directorship between the adviser with either the bidder or the target, the adviser is disqualified from acting

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15 False and misleading information is governed by s 38 of the Code.

16 (1988) 14 ACLR 336.

17 PN 1.3(8).

18 PN 4.3.

19 PN 4.3.

20 PN 4.3.

as an independent adviser. It thus can be observed that the law requires the adviser to be independent of both the bidder and the target.

### **What is the content of the IAC?**

The IAC must provide all such information as the shareholders, the board of the target and their professional advisers would reasonably require for the purpose of making an informed assessment as to the merits of the offer.<sup>21</sup> The IAC must disclose, inter alia, brief information of the bidder and the target.<sup>22</sup> Where the offer is a mandatory offer, details of the transaction which led to the triggering of the offer must also be included.<sup>23</sup>

The Code clearly states that the adviser must disclose all such information to the holder of the voting shares to which the takeover offer relates.<sup>24</sup>

Schedule 2 to the Code provides detailed guidelines for the IAC. It requires the disclosure of all information which may assist the target shareholders in making an informed decision. Most importantly, the details of the offer must be laid out; the salient terms and conditions of the offer including the consideration, the condition, and the duration of the offer and the method of settlement need to be stated clearly. When evaluating the offer, the adviser needs to look at the rationale for the offer and the bidder's plan for the target. Further, the adviser must take into account the bidder's intention with regard to the continued employment of the employees in the target company and of its subsidiaries. The impact of a takeover can be tremendous. It may, for instance involve a target which will immediately be liquidated following the completion of the takeover while the white knight who took over the company retains the subsidiary which is still a profit making company.<sup>25</sup>

The IAC should also include the directors' interests in the bidder as well as the target. Service contracts of the directors and any of the target subsidiaries must be sufficiently disclosed. The IAC must also include the board's recommendation.<sup>26</sup> The independent adviser is required to comment on the "reasonableness" of the offer and state its advice whether to accept or reject the offer.<sup>27</sup> The task of an independent adviser, as observed, is not only to assess whether the offer is reasonable but also to firmly state whether shareholders should accept or reject the offer. Where the takeover document contains a profit forecast, the adviser must evaluate on the reasonableness and the

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21 The Code, s 15(9).

22 PN 1.3(7).

23 PN 1.3(7).

24 The Code, s 15(9).

25 See the recent takeover of Maika Holdings by G Team Resources: "Westport's executive chairman to take over Maika Holdings", *The Star*, April 22, 2010.

26 Document Guidelines 3.2.

27 The Code, Sch 2 para 1(e).

accuracy of the forecast as well.<sup>28</sup> The adviser may also include in the report the limitation to the evaluation of the offer.

The directors may rely on the advice given by the adviser when recommending the shareholders to accept or reject the offer. It should be noted, however, that in the absence of detailed information on each shareholder, it will not be possible for the directors to know whether the recommendation suits each and every shareholder. Therefore, the advice given by the directors will normally require the shareholders to assess the information available to them or hire a professional to advise them on the suitability of the offer to their interests. Conversely, the directors may differ in their views with the one expressed by the independent adviser.

The board of the target directors' recommendation in response to the bidder's offer document is made in writing. An IAC is attached to it before it is sent to the shareholders of the target.<sup>29</sup>

### **Independent Advice Circulars: A closer look**

As noted above, the purpose for requiring the IAC is to assist the holders of the voting shares. Since the independent adviser has to comply with the Guidelines on Offer Documentation when preparing the IAC, we can observe a standard format and structure in the IACs. The author conducted a study on the IACs prepared from the year 2009 up to June 2010. A total of 15 IACs were reviewed. The author examined the report made by independent advisers focusing on the evaluation of the offer.<sup>30</sup> The following can be observed from the study:

#### **The evaluation of the offer**

In evaluating the offer, the following factors are taken into consideration:

(1) *The rationale for the offer*

The independent adviser will consider whether the rationale for the offer is considered reasonable. Below are some of the instances relating to the rationale of the offer:

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28 The Code, Sch 2.

29 The letter from the board of the target should elaborate on the details of the offer and its terms and conditions, which include the consideration, condition and duration of the offer, procedure for acceptance and the method of payment. It also provides the evaluation of the offer which includes the rationale, financial evaluation, industry outlook and the future of the target. Finally it includes the recommendation by the board of the target.

30 Generally the letter from the independent adviser should include the following:

- i. Introduction of the offer;
- ii. The terms of offer;
- iii. Limitations to the evaluation of the offer;
- iv. Evaluation of the offer comprising of the rationale, financial evaluation, industry outlook and future prospects; and
- v. Conclusion and recommendation.

- (a) the bidder has triggered the mandatory general offer (MGO) and it is mandatory for the bidder to make an offer to all the remaining holders of the voting rights in the target company;
  - (b) the bidder wishes to delist the target with a view to undertaking the restructuring and reorganisation exercise in order to achieve the target business objective;
  - (c) the bidder and the target have definite plans to expand and diversify the business of the target;
  - (d) the bidder intends to liquidate the target company and take control of the profit generating subsidiary.<sup>31</sup>
- (2) *Financial evaluation of the offer*

When making financial evaluation of the offer, the independent adviser takes into account, among other things:

- (a) *The historical share prices and trading volume of the target to reflect the prevalent market assessment of its value.* The IAC provides the historical market prices with the statistic/data mostly relying on Bloomberg. The study on the IACs reveals that there is no fixed period used in the IAC when projecting the historical share prices. The duration of the historical performance of the target ranges from a minimum of one year to a maximum of three years.<sup>32</sup>
- (b) *A relative valuation of the offer with comparable companies.* The independent adviser confines the list to mostly listed companies having similar principal activities with the target. It is however worth noting that the evaluation of the companies in a similar industry may not be directly comparable to the target due to various factors, which include among others, different asset bases, geographical location, marketability and liquidity of the shares, size and diversity of the respective businesses, profit track record, financial strengths and prospects.
- (d) *Comparison with the offer price of takeovers in companies having the same principal activities with the target.* There is no standard period applied in the IACs. The study shows that the independent adviser takes into account the offer price paid to the comparable companies ranging from a duration of three months to 12 months. The independent adviser will then assess whether the premium offered to the target shareholders is on par with the average premium offered to comparable companies which had undergone takeovers. The current practice as recommended by the Commission is to include

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31 Maika Holdings takeover by G Team Resources & Holdings Sdn Bhd.

32 Based on IACs prepared in 2009 to June 2010.

the offer price of comparable companies for 12 months preceding the takeover.

(3) *Overview and prospects of the industry in which the target group operates*

The IAC will state the prospects of the target against the country's economic background. The independent adviser also takes into account the prospects and outlook for the country's economy and examines the possibility for positive growth in the economy and the impact of such economic improvement on the target company in the future. In certain cases, depending on the nature of the target's business, the IAC also takes into account political factors and economic risks in the country and neighbouring countries.

(4) *Financial performance of the target*

The independent adviser will normally summarise the financial performance of the target based on the respective audited consolidated financial statements of the target. The study reveals that the duration applied differs from case to case. In the study carried out on the IAC, the audited consolidated financial statement as applied by the independent adviser ranges from 15 months to five years whereas the unaudited consolidated result ranges from six months period to nine months.

(5) *Prospects of the target or the target group*

The independent adviser evaluates the prospect of the target in the short term and medium term and the strategies for the various businesses carried out by the target and the target group.

(6) *Other considerations*

Other factors which the independent adviser has also taken into account include matters relating to the bidder's intention to delist the target or whether the bidder intends to compulsorily acquire the shares from dissenting shareholders under s 222 of the Capital Markets and Services Act 2007.

It is worth noting that from the observation made on the IACs, those IACs prepared prior to March 2010 also include the possible scenarios that the shareholders may encounter. For example, the independent adviser will lay down the effect of the offer where the bidder manages to secure 90% acceptances which will give rise to the bidder's right to invoke their compulsory acquisition power and the situation where 90% acceptances are not obtained. The inclusion of the above scenarios may not be much of assistance to the shareholders. The author observed that the IACs also include the long-term and short-term view to cater for shareholders who at the time of buying the shares intend to stay in the company rather than exiting the company and realising their investment whenever opportunity presents itself. The author observed changes in the IACs submitted to the Commission from the month

of March 2010. The IACs have also included the basis and assumptions of the valuation which they adopted. The independent adviser also disclosed the appropriate valuation methodologies and the justification for the adoption of such methodology in evaluating the target.<sup>33</sup> They also include the analysis of dividend yield and analysis of capital value, where the independent adviser states whether there is a potential gain if holders were to accept the offer.

Apart from forming its opinion on whether the offer is “fair and reasonable” the adviser is also required to advise the shareholders whether to accept or reject the offer. Such advice can be found in the final part of the IAC in the “conclusion and recommendation” part.

### **What is a fair and reasonable offer?**

As a matter of convention, independent advisers have evaluated on the “fairness and reasonableness” of an offer despite the fact that the Code requires the adviser to evaluate only on the “reasonableness” of the offer.<sup>34</sup> The Commission has allowed independent advisers to evaluate the offer based on the “fair and reasonable” standard as it is in consistent with an approach in other jurisdictions.<sup>35</sup> The Consultation paper made reference to s 640 of the Australian Corporations Act 2001, which requires that a target’s statement given in accordance with s 638 must include, or be accompanied by, a report by an expert that states whether, in the expert’s opinion, the takeover offers are fair and reasonable. Section 640 also requires an expert to give the reasons for forming such opinion.

The phrase “fair and reasonable” in normal legal usage is treated as a composite term; it is a single expression which has normally been taken to convey a single overall meaning. In Australia, however, when takeover bids are involved it has been a practice that the words “fair and reasonable” in s 640 are treated as two distinct criteria.<sup>36</sup> In *Re Rancoo Ltd*<sup>37</sup> Hayne J when referring to the phrase “fair and reasonable” said:

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33 Different valuation methodology is used which includes the discounted flow method, the RNAV method, the earnings multiple approach method. The improvement on financial evaluation of the offer can be seen in IAC submitted on March 20, 2010.

34 The Code, Sch 2 para 1(e).

35 See Public Consultation Paper No 2/2010, *supra*, n 3, p4, para 3.1.2. Rule 2 of the Hong Kong Code on Takeovers and Mergers and Share Repurchases specifically requires a financial adviser to state whether the offer is “fair and reasonable”. Similarly s 640 of the Australian Corporations Act 2001 requires the expert to state whether the offer is “fair” and “reasonable”. On the other hand, in New Zealand and Singapore, no specific requirement exists as to the offer to be “fair and reasonable”. However, as a matter of practice, the “fair and reasonable” standard is widely used by independent advisers.

36 See Australian Securities and Investment Commission, *Content of Expert Report*, Regulatory Guide 111 (October 2007) at RG 111.9.

37 (1995) 17 ACSR 206 at 207, cited in Hulme, S E K, “Section 640 of the Corporations Law: Independent Experts’ Reports and the RTZ Ltd Takeover of Comalco Ltd” (2001) 19 *Company & Securities Law Journal* 134 at 141.

... the impression I have is that "fair and reasonable" is but a single expression intended to convey a single overall meaning which is not to be identified by reference to particular constituent elements."

The empirical study carried out by the author on the IACs clearly shows that as a matter of practice, independent advisers have treated "fair and reasonable" as a composite term. It's worth noting that despite the widespread usage of the term "fair and reasonable" in the IACs in Malaysia, neither the Code nor the court has formulated a precise, uniform definition of a "fair and reasonable" offer.

### *Defining "fair" and "reasonable"*

What is "fair and reasonable" by definition varies from transaction to transaction. How one defines fair and reasonable in one transaction will greatly affect what price may be considered fair and reasonable in another. The Commission now, in its review, steps in to inform the adviser what is it to look at in forming its opinion whether the offer is "fair" and "reasonable". In the Consultation Paper, the Commission stated that its aim is to "provide a simple and clear framework for analysis that can be easily understood by users".<sup>38</sup> The Paper made a reference to s 640 of the Australian Corporations Act 2001 which applies to on-market and off-market takeover offers.<sup>39</sup> A target statement issued in response to the bidder's statement must contain the report of an expert giving an opinion as to whether the takeover offer is fair and reasonable and setting out the reasons for forming that opinion.<sup>40</sup> The Consultation paper also made reference to the Regulatory Guide 111 issued by the ASIC which provides guidance on how to draft an expert report in line with the requirements of the Australian takeover law. RG 111 outlines the nature of the opinion which is required from the expert and discusses the considerations underlying the concepts of fairness and reasonableness which the expert should assess.<sup>41</sup>

### *"Fair"*

The Guidelines on Offer Documentation require independent advisers to assess the "fairness" of the offer. The Commission now proposes that the term "fair" in relation to the offer price must be at least equal to the value of the

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38 Public Consultation Paper No 2/2010, *supra*, n 3, p 8.

39 Renard, I and Santamaria, J, *Takeovers and Reconstructions in Australia* (Sydney: LexisNexis Butterworths, looseleaf), section [2012].

40 Renard, I and Santamaria, J, *supra*, n 39. The Corporations Law, s 640 requires an expert's opinion where the bidder company has at least 30% voting power in the target company or the bidder and the target share common directors. Expert's opinion is equally required under ss 611, 667A and ASX LR Ch 10. It is however worth noting that ASIC applies important differences in the meaning of and considerations underlying the 'fair and reasonable' test in the context of s 640 as compared to s 611. See Renard, I and Santamaria, J, *supra*, n 39 at [2012].

41 Renard, I and Santamaria, J, *supra*, n 39.

securities.<sup>42</sup> The proposed guidelines tie the question of “fairness” to value alone. Thus when forming its opinion on whether the offer is “fair” or not, an independent adviser must only look at the value of the securities. This approach follows RG 111.10 which indicates that the Australian Securities and Investment Commission (ASIC) views fairness as a quantitative consideration which involves a comparison of the value to be surrendered versus the value to be received under a proposed transaction.<sup>43</sup>

How should the adviser assess the value of the offer? There are a variety of valuation methods available to the adviser when assessing the value of the offer. The Commission leaves the adviser to choose the valuation methodology based on the adviser’s skill and judgment.<sup>44</sup> The Commission however provides guidance on how experts should analyse a proposed transaction.<sup>45</sup> Firstly, the adviser must use more than one valuation methodology and justify its choice of methodologies.<sup>46</sup> The choice of the methodologies however must be an appropriate one.<sup>47</sup> An inappropriate choice of valuation methodology might be misleading. In addition, failure to take sufficient care and skill in the preparation of the advice circular will expose the adviser to liability.<sup>48</sup>

Secondly, the adviser must compare and comment on the differences and the results of the methodologies used in the valuation. Thirdly, the adviser must base its valuation on reasonable assumptions and disclose all the assumptions used in the valuation. The adviser must include a sensitivity analysis which sets out the impact of foreseeable material changes where relevant. Finally, the adviser must provide its opinion on the value for the subject of the evaluation.

### *The appropriateness of the methodology*

The appropriate valuation method depends very much on the type of company. An adviser is left to make the choice of methodology based on his skill and judgment.<sup>49</sup> When choosing valuation methodologies, however, the adviser is required to justify the reasons for such selection and its appropriateness. Whatever method is adopted, this should produce the highest and best value for the security or asset in question.<sup>50</sup> One significance of stating the

42 Public Consultation Paper No 2/2010, supra, n 3 p 8.

43 Renard, I and Santamaria, J, supra, n 39, [2012].

44 Public Consultation Paper No 2/2010, supra, n 3, p 12.

45 Public Consultation Paper No 2/2010, supra, n 3. See para 4.6.1(a)–(d).

46 In contrast, the Australian regulatory guide states that “an expert should, when possible, use more than one valuation methodology”. It is worth noting that the SC has not come up with the detail guidelines. Perhaps the SC does not mean to impose that in all situations, an adviser must use more than one valuation methodology.

47 Public Consultation Paper No 2/2010, supra, n 3, para 4.6.2.

48 See *Duke Group Ltd v Pilmer* (1999) 31 ACSR 213 and *Re EPHS Ltd* [2002] ATP 12, cited in RG111.49.

49 Public Consultation Paper No 2/2010, supra, n 3, para 4.6.1.

50 Renard, I and Santamaria, J, supra, n 39, [2012].

valuation methodologies adopted is to allow the professional adviser of the shareholder or the board of directors to replicate the adviser's work and assess the valuation.<sup>51</sup>

In determining the appropriateness of the methodologies, the consultation paper provides the following factors for an adviser to consider.<sup>52</sup> Firstly, when valuing listed securities where there is a liquid and active market, the adviser may take into consideration the market price for the securities. The adviser must also consider the possibility that the said market price may not reflect their real value. Secondly, the adviser may consider the discounted cash flow method and the estimated realisable value of any surplus assets of the company. Thirdly, the adviser may apply an appropriate earnings multiple to the estimated future maintainable earnings of the target company. Fourthly, the adviser may take into consideration the amount that would be available for distribution to shareholders in an orderly realisation of assets. Finally, an adviser may consider any precedent offer undertaken by another company as a basis for the valuation of the target's securities. It should be noted that the list, however, is not exhaustive. An adviser is free to consider other factors which will assist in determining the right methodology to be adopted in the valuation process. It is worth noting that the factors enumerated above resemble those stated in the Australian regulatory guide.<sup>53</sup> There are also decided cases in Australia which provide some guidance to independent advisers. In *Re Weedmans Ltd*<sup>54</sup> it was held that a valuation based upon the amount which shareholders could realise assuming an orderly realisation of assets was an appropriate basis to use where it exceeded the price offered. However, this view was modified by Needham J in *Wright Heaton Ltd v PDS Rural Products Ltd*<sup>55</sup> where it was held that, although the net tangible asset value exceeded the offer price, it was misleading to consider the net tangible assets because, for all practical purposes in the circumstances of the case, the value was unobtainable and therefore not its highest and best use.

### *The question of value ranges*

The consultation paper obliges an adviser to place a range of values in the valuation process.<sup>56</sup> Here, the advisers will have to consider, for example, the price offered to comparable companies in a takeover offer. The adviser must state where the target company stands when compared to comparable companies in terms of size of the companies, their assets backing, their net tangible assets, their return on assets etc. The consultation paper encourages

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51 See RG 111.52.

52 Public Consultation Paper No 2/2010, supra, n 3, para 4.6.2(a)–(d).

53 See RG 111.53

54 [1974] Qd R 377. Cited in *Takeovers and Reconstructions in Australia*, supra, n 39, [2012].

55 [1982] 2 NSWLR 301; (1982) 7 ACLR 140; 1 ACLC 341. Cited in Renard, I and Santamaria, J, supra, n 39, [2012].

56 Public Consultation Paper No 2/2010, supra, n 3, p 13

the adviser to state the range as narrowly as possible in order to reflect the most accurate value for the target's securities. Where the adviser is unable to give a narrow range owing to uncertainty, it must justify in the circular the factors which created the uncertainty; the adviser must also justify how, despite the uncertainty, it has reached its findings.<sup>57</sup> There are a number of factors which may cause the adviser to be unable to provide a narrow range; a simple example would be where the target company's size, asset backing etc. is far behind comparable companies. It is worth noting that a similar requirement in Australia which obliges advisers to give a narrow range was criticised by Hulme, who believes that "a range remains a range and it will sometimes be of significant width".<sup>58</sup>

### *Evaluation of consideration other than cash*

Where the bidder offers securities, whether listed or unlisted, as consideration, the adviser must examine the value of those securities and compare it with the valuation of the target's securities.<sup>59</sup> The adviser may take into account the control premium for the target company. Where the adviser uses the market price of the offer shares as a measure of the value of the consideration offered, the adviser may take into considerations the depth of the market for the shares offered as consideration and the volatility of the market price.<sup>60</sup> The adviser may also want to consider whether or not the market value is likely to represent the post transaction value if the takeover offer is successful.<sup>61</sup>

### *"Reasonable"*

Generally an offer is reasonable if it is fair. Can an offer be reasonable despite being not fair? The Consultation Paper suggests that the "reasonableness" of the offer should not be tied up to the value of the securities of the target. If we were to tie up the "fairness" of an offer to the value of the securities alone, it may then be possible to hold an offer to be "reasonable" based on other factors. In other words, "reasonableness" encompasses all other non-quantitative factors which are considered material to shareholders in so far as it affects their decision-making on the matter they are required to consider or approve.<sup>62</sup> It is worth noting that Renard and Santamaria observed that in practice, the lower the offer price is compared to the range which the expert considers as fair, the less likely it is that the expert will conclude that the offer is reasonable.<sup>63</sup>

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57 See Public Consultation Paper No 2/2010, supra, n 3, p 13.

58 Hulme, supra, n 37 at 148.

59 Public Consultation Paper No 2/2010, supra, n 3, para 4.5.1.

60 Public Consultation Paper No 2/2010, supra, n 3, para 4.5.3.

61 Public Consultation Paper No 2/2010, supra, n 3, para 4.5.3.

62 Renard, I and Santamaria, J, supra, n 39, [2012].

63 Renard, I and Santamaria, J, supra, n 39.

In evaluating the “reasonableness” of the offer, the Commission suggests that the adviser take into consideration all factors which will lead or contribute to the offer to be considered “reasonable”.<sup>64</sup> As a guide, the Commission suggests that the adviser consider a number of factors which include, among others, the existing control the bidder and its concert party have in the target company, the liquidity of the market for the target’s securities, pre-offer and post-offer performance of the market price of the target’s securities, the possibility of the major shareholders accepting the offer which will result in the offer being successful and the likelihood and value of alternative offers before the closure of the offer.<sup>65</sup> The independent adviser may also want to consider any special value that the bidder will derive, including synergies that can be achieved, the benefits accruing to the bidder from increasing control in the target and whether the advantages and disadvantages of accepting an offer are greater to the bidder or the target.<sup>66</sup> It is worth noting that the factors for the adviser to consider suggested above are similar to the Australian guidelines.<sup>67</sup> Now that the term “reasonable” is defined by looking at other factors than the value of the securities, it is possible for the adviser, after considering all the relevant factors, to come to a conclusion that the offer is “reasonable” despite being “not fair”. In such a situation, the adviser must further explain the reasons why it considers the offer as “not fair” but “reasonable”. Thus despite the fact the adviser concludes that the offer undervalues the securities of the target, the adviser may state that the offer meets the standard of “reasonableness” where, for example, the offer is better than any alternative with which shareholders are likely to be presented. In such a situation, the proposed guidelines require the advisers to inform the shareholders how such conclusion will affect the course of action required of them.<sup>68</sup>

From the above discussion, it can be observed that the proposed Guidelines require the adviser to make two separate judgments, i.e. to state whether the offer is “fair” and whether it is “reasonable”, rather than reaching a single overall assessment. The approach suggested to the IAC clearly adopts the Australian approach. We also observe that the Australian Regulatory Guide in relation to experts’ reports has lent considerable assistance to the current review proposed by the Commission. However, it is worth noting that the decoupling of the phrase “fair” and “reasonable” in Australia does not come without criticism. In *Re Rancoo*,<sup>69</sup> for instance, the expert report suggested that the selective capital reduction was “not fair” but “reasonable”, Hayne J stated:

it would seem to me that to divide the expression “fair and reasonable” ... is to invite the expert to engage upon a task which requires consideration,

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64 Public Consultation Paper No 2/2010, supra, n 3, para 4.1.4.

65 Public Consultation Paper No 2/2010, supra, n 3, para 4.1.4.

66 Public Consultation Paper No 2/2010, supra, n 3, para 4.1.4.

67 See RG 111.12.

68 Public Consultation Paper No 2/2010, supra, n 3, p 10, para 4.1.5.

69 (1995) 17 ACSR 206.

in the first case, of circumstances that may be divorced to some extent from those which in fact obtain, while at the same time requiring that expert, later, to give an overall assessment of the worth of the proposal ... it is enough if I say that I doubt that is an approach that is particularly helpful in connection with a reduction of capital. Indeed in some cases it may obscure more than it illuminates.<sup>70</sup>

In the above case, the rationale advanced by the expert was that, while the return of capital to the outgoing shareholders was higher than its assessed value of the remaining shares in the company, an ancillary transaction was beneficial to the company which made the proposal "reasonable". In a subsequent decision, *Quatro Ltd v Argo Investments Ltd and others*,<sup>71</sup> a case also concerning reduction of capital, the court took note of the need to prove that the reduction is "fair and reasonable" to the shareholders. This case went to court after the amendments made to the Corporations Law which came into operation on July 1, 1998 where the court is no longer required to confirm a reduction of capital provided, among others, that the reduction is "fair and reasonable". The court was of the opinion that the words "fair and reasonable" should carry the same meaning with "fair and equitable". The court made reference to *Re Allgas Energy Ltd*,<sup>72</sup> where Thomas J also used the expression "fair and reasonable" without stating that the expressions bore different meanings.

In *Zenyth Therapeutics Ltd v Smith*<sup>73</sup> again the Supreme Court of Victoria considered the expert report but this time in relation to a scheme of arrangement. The expert here concluded that the scheme of arrangement was "not fair"; nevertheless it was "reasonable". The defendant in this case opposed the option scheme principally on the basis that there was insufficient disclosure in the explanatory booklet about the rights of option holders in the event that the share scheme proceeded. The company acknowledged, in the explanatory booklet, the independent expert's conclusion that the option scheme was "not fair" because for six series of options, the option scheme consideration was less than the independent expert's assessed value. The defendant further argued that the independent expert advanced three distinct reasons why the option scheme was "reasonable" which were, on analysis, inadequate and unconvincing. The court was of the opinion that it should be cautious when dealing with expert reports which approve any scheme where the independent expert considers "not fair", particularly when it may involve expropriation at an undervalue. The court observed:

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70 See also Ford, H A J, Austin, R P and Ramsay, I M, *Ford's Principles of Corporations Law* (Sydney: LexisNexis Butterworths, looseleaf), at 23,510: "to inject an intermediate premise to the effect that the offer is unfair but reasonable seems unnecessary and confusing".

71 (1999) 32 ACSR 239; [1999] VSC 171.

72 (1988) 27 ACSR 729.

73 [2006] VSC 436.

A scheme involving an offer of an undervalue, which is not fair, should not generally be considered reasonable unless it is accompanied by some positive compensatory feature. The fact that the security holders are unable to exact fair, or better, consideration through any avenue alternative to the scheme would not necessarily render an unfair scheme reasonable in the relevant sense ... The independent expert's conclusion that the scheme was reasonable, and in the option holder's best interests, was not clear or logically compelling.

It can be observed that difficulties may arise where the adviser is of the opinion that the offer is "not fair" but "reasonable". The real difficulty, in the author's view, is when the advisers in Malaysia have to advise the shareholders to either accept or reject the offer which in their opinion is "not fair" but "reasonable". This may place the advisers in a difficult position. Unless the advisers can offer logically compelling reasons when recommending the offer to be "reasonable" despite the fact that it is "not fair", the advisers' report may backfire or expose them to liability. In Australia, where an independent expert report is required, it will often form part of the basis for the directors' recommendation. What the expert must do is to state whether, in the expert's opinion, the offer is "fair" and "reasonable" and the justifications underlying such opinion. The expert is not required to state whether the shareholders should accept or reject the takeover offer. It is also worth noting that there have been two expert reports in relation to takeovers of a listed company on the ASX since January 1997 where the expert formed an opinion that the offer was "not fair" but "reasonable".<sup>74</sup> In Malaysia, since the publication of the Consultation Paper, the author observed that out of seven IACs which adhere to the suggestion to treat "fair and reasonable" as a non-composite phrase, only one suggests that the offer is "not fair" but "reasonable".

## Conclusion

The move by the Commission to decouple the term "fair" and "reasonable" in the IAC is aimed at providing assistance for the shareholders to make an informed decision; in other words, it seeks to protect the shareholders when deciding on the offer. Will the proposed changes enhance the IAC and provide a better tool for the shareholders? After examining the IACs, the author finds that those IACs prepared in mid-2010 show improvement. The advisers, for example, do not only state the price of comparable companies or condition of the industry. They have also included their comment after analysing the research database. Advisers have also confined themselves to the value factor alone when considering the "fairness" of the offer. The "reasonableness" of the offer, on the other hand, is assessed by looking at factors other than the value of the offer. This obviously reflects that the current IACs are prepared with close guidance by the Commission in meeting the objective of the

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74 See <http://www.connect4.com.au>.

law. Despite the fact that the term “fair and reasonable” is not treated as a compound phrase and has departed from the normal usage, it has to some extent allowed the shareholders to be enlightened when reaching their conclusion on the fairness and reasonableness of the offer. It also allows the shareholders to know the reasons upon which the advisers based their opinion on the fairness and reasonableness of the offer. Having mentioned that, it is also important to take note that besides relying on the IACs, shareholders with specific investment objectives are advised to refer to their respective advisers to advise them further on the fairness and reasonableness of the offer to meet their investment objective.

The court must also take a similar approach when defining the terms “fair and reasonable” when considering matters falling under transactions which require the preparation of IACs. It is also hoped that based on the proposal in the Consultation Paper the Commission will clearly lay down the guidelines for the independent advisers; the same guidelines should be able to assist the court, where dispute arises, when determining whether an offer is “fair” and “reasonable”.