

The SFC's Guidance on Corporate Transactions and the Use of Valuations

The SFC has become increasingly concerned that some listed companies are acquiring or selling assets at improperly assessed prices, resulting in losses to listed companies and their shareholders.

Summary

The Securities and Futures Commission (SFC) recently issued (a) a guidance note on directors' duties in the context of valuations in corporate transactions (the Guidance Note); (b) a circular to financial advisers regarding valuations in corporate transactions (the Circular); and (c) a statement on the liability of valuers for disclosure of false or misleading information (the Statement). The key points to note in relation to the abovementioned documents include:

- Directors should ensure that proper investigation and due diligence on, and appraisal of the worth of the asset or target company are conducted.
- Directors should consider the need for a valuation by a professional valuer of an asset or a target company that the listed company is proposing to acquire or dispose of.
- Directors should take reasonable steps to verify the accuracy and reasonableness of material information that is likely to affect the valuation of the asset or target company, including financial forecasts, business plans and assumptions.
- Directors' reliance on a valuation must be reasonable in all circumstances.

The Guidance Note will be likely to have the following effects:

- Directors of listed companies will need to conduct a thorough due diligence review of the assets to be acquired or disposed or the target company, including considering whether or not a professional valuer should be appointed and verifying the accuracy and reasonableness of information that is likely to affect valuation of the asset or target company.
- Listed companies and their advisers will need to properly document all the relevant due diligence steps that have been undertaken and in particular, all the relevant discussion in relation to valuation of the asset or target company that the listed company is proposing to acquire or dispose of.

- The appointment of professional valuers in acquisition or disposal by listed companies will likely increase especially in transactions that are significant in size for the listed company.
- Any SFC investigation is likely to focus on whether proper investigation and due diligence have been conducted on the value of the asset to be acquired or disposed or target company, including the engagement (or non-engagement) of a valuer and if reliance on any valuation report has been reasonable, and the SFC may bring proceedings against listed company directors who do not act in accordance with the Guidance Note.

Investigation and Due Diligence

In making the decision to invest or divest, directors should carry out independent and sufficient investigation and due diligence, which includes:

- Understanding the nature of the asset or the business of the target company to make informed deliberations about the proposed investment or disposal.
- Considering all information that is relevant to assessing the merits of the proposed investment or disposal.
- Taking all reasonable steps to verify the accuracy and reasonableness of material information that is likely to affect the valuation of the asset/target company, including being satisfied that the financial forecasts and assumptions are reasonably justified.
- Seeking assistance of professional valuers or other advisors if appropriate.
- Seeking further information from the vendor and any other persons if appropriate.

The above requirements for conducting investigation and due diligence effectively mean that directors should not blindly and unquestioningly accept financial forecasts, assumptions or other information provided to them, typically by a vendor or the management of the target. They must assess and consider the information provided to them with a critical mind.

Needless to say, the directors are subject to the duties imposed on them by law and the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited to act in good faith in the interests of the listed company and exercise due and reasonable care, skill and diligence when considering or approving corporate transactions.

Engaging a Valuer

As required by the Guidance Note, the directors will also need to consider the need for a valuation of the proposed investment or disposal by a professional valuer, particularly in certain situations, such as when the directors do not themselves possess sufficient experience or expertise in either the field of business of the proposed investment/disposal or in valuation or when the size of the investment or disposal is significant in relation to that of the listed issuer. Where the directors decide that appointing a professional valuer is unnecessary, the directors must have considered all the relevant factors. As a matter of best practice, all of the relevant discussion leading to the decision must be properly documented.

Notably, however, appointing a valuer does not absolve directors of their responsibility or liability. Directors are required to exercise independent judgment and bring their mind to bear on the issues having regard to the advice and opinions of professionals and other experts.

In appointing a professional valuer, the directors should ensure that the professional valuer is independent and has no conflict of interest with regard to the listed company or the acquiring company, is suitably qualified and of sufficient reputation and has the relevant expertise and adequate resources to perform its role. The scope of the valuer's mandate should be appropriately drafted to ensure that the valuation report will be relevant and useful in aiding the directors to determine the fair and reasonable offer price for the asset or target company and to ensure the directors can reasonably rely on the valuation.

Reliance on the Valuation

Directors' reliance on a valuation report must be reasonable in all circumstances. Placing excessive or unquestioning reliance on a valuation report or the advice of any other adviser may amount to failure to properly discharge directors' duties. Directors have a positive duty to devote the necessary time and attention to bring their own judgment to bear on the matter and make an informed decision with regard to a proposed investment or disposal, which includes:

- Maintaining an engaged and critical attitude towards the basis of computation, scope of review, assumptions, limitations and qualifications and methodologies.
- Analysing the valuation report.
- Enquiring with the valuer to satisfy themselves about the valuation and its assumptions/methodology etc.
- Calibrating the degree of directors' involvement in the transaction having regard to the reasonably anticipated risks involved, the size or significance of the assets/target company being acquired or disposed, the nature of the transaction and any other matter calling for critical and detailed attention.

The Circular and the Statement

The Circular was issued to financial advisers in relation to their advisory work on valuations in corporate transactions. Financial advisers are reminded that they must comply with all applicable requirements under the Corporate Finance Adviser Code of Conduct. In particular, financial advisers should not rely solely on representations made by the directors, their delegates or other third parties. Financial advisers should conduct their own assessment and undertake reasonableness checks as appropriate on the forecasts, assumptions, qualifications and methodologies of the valuation and the directors' decision on whether or not to appoint a professional valuer.

The Statement provides that a valuer may be liable if it has authorized or was concerned in a listed company's disclosure of false or misleading information and the valuer knows that, or is reckless or negligent as to whether the information is false or misleading, under section 277 or 298 of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the SFO). If a valuer contravenes section 277 or 298 of the SFO, the SFC may also bring proceedings under section 213 of the SFO for remedial orders, including an order that the valuer pay compensation to restore any person to any transaction to the position he or she were in before the transaction was entered into. Separately, if a

valuation is included in a prospectus with the consent of the valuer, the valuer may incur civil liability to pay compensation to investors who subscribed for shares or debentures in the company on the faith of the prospectus and suffered loss/damage by reason of any untrue or misleading statement in the prospectus made by the valuer.

Conclusion

The Guidance Note, the Circular and the Statement not only aim to raise the standards expected of directors of listed companies in assessing valuation in corporate transactions, but also to place a higher standard of responsibilities on financial advisers and valuers so that listed companies will be acquiring or selling assets at properly assessed prices that will be in the best interests of the listed company and its shareholders as a whole. The SFC's abovementioned publication will likely prompt listed companies to conduct more thorough due diligence reviews before acquiring or disposing of assets or target companies. Failure to adhere to the Guidance Note may result in investigation by the SFC and an order being imposed against the listed company directors, including but not limited to disqualification, compensation and other orders pursuant to section 214 of the SFO.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Cathy Yeung
cathy.yeung@lw.com
+852.2912.2622
Hong Kong

William Woo
william.woo@lw.com
+852.2912.2628
Hong Kong

Terris Tang
terris.tang@lw.com
+852.2912.2719
Hong Kong

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit <http://events.lw.com/reaction/subscriptionpage.html> to subscribe to the firm's global client mailings program.