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The Board's Role in M&A Transactions

In her regular column on corporate governance issues, Holly Gregory explains recent developments that add complexity to a board's role in M&A transactions, and examines issues that a board should consider when evaluating a proposed deal.



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Holly counsels clients on the full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

More M&A activity over the next 18 months is expected due to continuing improvements in economic conditions, significant cash reserves in corporate hands, increases in hedge fund activity and investor pressures for growth in shareholder returns.

Whether a potential M&A transaction is initiated or welcomed by the company to be acquired or results from an unwelcome suitor's offer, the board plays a critical role. The board must evaluate whether the transaction is in the best interests of the company and its shareholders such that it should be pursued or rejected.

Two current trends add complexity to the board's role:

- The increase in shareholder activism focused on M&A transactions (see *Box, Shareholder Activism in the M&A Context*).
- The virtual certainty that an M&A transaction will lead to litigation.

This article explores the board's role in light of these complexities and discusses:

- The litigation risk arising from an M&A transaction, and the standards of judicial review for challenged transactions.
- Recent Delaware cases involving potential conflicts of interest of the board and its financial advisors.

- Steps a board should take to be well-prepared for any M&A transaction that may arise.
- Issues that boards should consider when evaluating a proposed deal.

LIKELIHOOD OF LITIGATION

It is estimated that in 2013 approximately 97% of public M&A deals over \$100 million resulted in a legal challenge. The most common lawsuits arising from M&A transactions allege a breach of fiduciary duty by one or more directors. Therefore, it is highly likely that a board's decisions and decision-making processes related to M&A will be subject to potential scrutiny in a lawsuit. Although these cases have a high rate of success for defendant directors, and are often dismissed in the early stages, the pressures to settle are considerable given the time, attention, costs and uncertainties associated with litigation.

Given these factors, it is critical that the process the board follows during its consideration of an M&A transaction is sound. Informed board deliberation and a process untainted by conflict are key. The board's fiduciary duties of loyalty, care and good faith provide the framework for the board's consideration of an M&A transaction and for judicial review. When board actions are challenged as a breach of fiduciary duties, the applicable standard of judicial review, which relates to the important issue of who bears the burden of proof, depends on the nature of the deal and whether there are conflicts of interest. In most cases (those in which the business judgment rule applies) courts will hesitate to second-guess decisions of directors and will place the burden on plaintiffs to prove that board decisions were not made in good faith by independent and disinterested directors on an informed basis.

STANDARDS OF JUDICIAL REVIEW

The standard of review that a court will apply to review a transaction that has been challenged on breach of fiduciary duty grounds has significant implications for the likelihood that the case will withstand a motion to dismiss or a motion for summary judgment, and attendant pressures to settle. While this discussion is based on Delaware court decisions, in many cases the principles discussed are applicable to other jurisdictions as well.

Business Judgment Rule

Courts hesitate to second-guess a board's judgments and, for that reason, in a claim for breach of fiduciary duty, courts generally will presume that directors acted on an informed basis and in the good-faith belief that the action taken was in the best interests of the company. A plaintiff can overcome this judicial presumption by showing that directors did not act on an informed basis or in good faith, or that the decision was tainted by a conflict.

If the plaintiff succeeds in rebutting the business judgment rule presumption, the court will engage in a searching analysis of the board's decision, applying the "entire fairness" test.

Enhanced Scrutiny

While courts will defer to the business judgment of boards in most cases, they will apply enhanced scrutiny in certain

Shareholder Activism in the M&A Context

Shareholder activism is expected to play a significant role in M&A activity in 2014 and beyond, as the number of hedge funds pursuing activist strategies and the assets under their control continue to expand. Notably, activist hedge funds in the US are estimated to have between \$80 and \$100 billion in assets as of 2013 year end.

Pressures for returns to investors and competition in the sector are expected to continue to drive a high level of activity, including attacks on announced deals. With support from public pension funds, other institutional investors and often proxy advisory firms, this activity carries a fairly high likelihood of success in pressing for improved deal economics, termination of a transaction or the inclusion of one or more dissident directors on the board.



Search [Preparing for Shareholder Activism](#) for more on understanding and preparing for activist approaches.

circumstances. For example, enhanced scrutiny is applied when a board approves a transaction to sell the company, or when a board implements defensive measures in response to an unwanted advance or perceived threat. In these circumstances, courts will scrutinize:

- The board's decision-making process.
- The information on which the decision was based.
- The reasonableness of the board's actions.

In a change-of-control transaction, the board is required to achieve the highest value reasonably available for shareholders. With the adoption of defensive measures, the board must prove that it had reasonable grounds to believe that a threat to the company existed and the defensive actions taken must have been reasonable in relation to the perceived threat.



Search [Fiduciary Duties of the Board of Directors](#) for more on the fiduciary duties of the board.

Entire Fairness

If the business judgment rule presumption is rebutted, the board will bear the burden of proving that the transaction was entirely fair, both as to:

- Process or "fair dealing" (how the transaction was initiated, structured and negotiated).
- "Fair price" (a price that a reasonable seller would consider as within a fair-value range).

This level of scrutiny applies where plaintiffs can make a showing that directors did not act on an informed basis, in good faith or without conflict (such that the business judgment rule presumption is rebutted).

However, the burden of proving entire fairness will shift to the plaintiff where a transaction with affiliates (directors, management or a significant shareholder) that involves inherent conflicts is approved by a special committee of independent and disinterested directors with appropriate powers and independent advisors, or a majority of minority shareholders. In limited circumstances (such as a freeze-out merger by a controlling shareholder), directors may receive the benefit of the business judgment rule presumption if both a special committee is used and the transaction is approved by a majority of minority shareholders.

RECENT DELAWARE CASE LAW DEVELOPMENTS

When reviewing a breach of fiduciary duty claim related to an M&A transaction (or other types of fiduciary duty claims), courts are particularly sensitive to real or potential conflicts of interest that may have tainted a board's objective and informed deliberative process. Of particular concern, as highlighted in recent Delaware cases, are conflicts related to controlling shareholder interests and the interests of financial advisors.

CONTROLLING SHAREHOLDER TRANSACTIONS

In *In re MFW Shareholders Litigation*, the Delaware Court of Chancery granted summary judgment to the defendant directors and applied the business judgment rule rather than the higher entire fairness standard in the context of a breach of fiduciary duty claim arising from a going private merger with a controlling (43%) shareholder (67 A.3d 496 (Del. Ch. 2013), aff'd, *Kahn v. M & F Worldwide Corp.*, C.A. No. 6566, 2014 WL 996270 (Del. Mar. 14, 2014)). The court held that the more deferential business judgment rule standard applied where the merger was conditioned on the approval of both:

- A special committee of independent and disinterested directors.
- A majority of the minority shareholders.

The court explained that earlier precedent had provided that review under the entire fairness standard applied to controlling shareholder transactions, but that where the transaction is approved by either a special committee of independent and disinterested directors or a majority of minority shareholders, the burden would shift to the plaintiff to prove that the entire fairness standard was not met. According to the *MFW* court, reliance on dual procedural protections afforded the minority shareholders greater protection, and the court should apply the more deferential standard of review of the business judgment rule to encourage controlling shareholders to rely on this dual procedural protection.

FINANCIAL ADVISOR CONFLICTS

Financial advisor conflicts have also received considerable attention over the last several years (for example, see *In re Del Monte Foods Co. Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011) and *In re El Paso Corp. Shareholder Litigation*, 41 A.3d 432 (Del. Ch. 2012)).

In a recent post-trial decision, the Delaware Court of Chancery held a target company's financial advisor liable for aiding and abetting fiduciary duty breaches by the target's directors (*In re Rural Metro Corp. Stockholders Litigation*, C.A. No. 6350, 2014 WL 971718 (March 7, 2014)). The directors had settled the claims against them prior to trial. The court found that the financial advisor had been motivated to earn large fees by providing stapled financing to a particular bidder and had manipulated the sale process to favor that bidder, including by providing misleading valuation materials for the board that made the bidder's proposal appear more attractive. These misleading materials were then included in the target company's proxy materials used in connection with the shareholders' meeting held to approve the transaction.

PREPARING FOR POTENTIAL DEAL ACTIVITY

Given the high likelihood of shareholder litigation related to M&A transactions and the importance of ensuring an informed decision-making process that is untainted by conflict, board involvement should begin well before any M&A transaction appears on the horizon.

As part of its oversight of corporate strategy, the board should ask management the questions below on a regular basis to ensure that the directors understand the business context in which issues relating to M&A may arise. The board should also clearly communicate its expectations about management's obligations to inform and involve the board early and often regarding any potentially material transactions under consideration.

The chairman of the board and/or independent lead director should ensure that the board's agenda allows adequate time for directors to explore these questions with management. Many companies devote a special session annually to strategic issues, including M&A. The board should focus on both the company as a potential acquiror and as a potential target (either friendly or hostile).

Areas for consideration include:

- **The company's strategic direction.** Does the company clearly explain its strategic direction in its public documents? How does M&A activity fit into management's current view of corporate strategy?
- **Potential opportunities and obstacles.** What are the potential opportunities (and related risks) available for growth through an acquisition? Are there regulatory barriers that would need to be overcome? How would an acquisition likely be financed? What are the arguments that the company would be more viable if it were to sell or spin off businesses, or merge with another company?
- **Current industry-specific M&A trends.** What are the current M&A trends in the company's industry?
- **An up-to-date understanding of the board's fiduciary duties.** Are there any recent legal developments affecting the board's fiduciary duties?
- **The company's vulnerabilities.** Is the company vulnerable to an approach (for example, because of an undervalued stock price, internal dissension, business lines or assets that are particularly attractive, or poor performance against peers)?

- **The company's shareholders.** Who are the company's main shareholders? Is the company actively monitoring its shareholder base? Do any activists own stock? Does the company regularly have discussions (subject to Regulation FD restrictions on disclosure of material nonpublic information) with its large shareholders about their concerns, including discussions relating to any sympathies toward potential activist arguments?
- **Takeover defenses and approach responses.** What takeover defenses are in place at the company? Does it have a shareholder rights plan (poison pill) in place or on the shelf? How are shareholders and their proxy advisors likely to react if a shareholder rights plan is implemented, and how could implementation be managed? Do the company and the board have a plan in place as to how to respond to an approach?
- **Delegating authority to management.** Has the board considered clearly delegating authority to management, in line with the company's strategy, to engage in deals that fall below a predetermined materiality threshold?

EVALUATING A DEAL

Although M&A deal ideas are typically proposed by the senior executive team, the boards of both the acquiring and target companies must decide whether a potential material transaction can proceed beyond an initial exploratory phase. Typically, the board of a potential acquiror would need to approve early exploration of a material transaction.

While there is no single blueprint for board involvement in a deal process, there are certain issues that all boards should be aware of. A board evaluating a proposed deal is well-advised to:

- **Apply constructive skepticism.** The board provides value by asking hard questions and challenging and testing management's assumptions in an effort to ensure that all reasonable aspects of the potential deal have been considered. Viewing the proposal through a lens of constructive skepticism may be difficult when the CEO and other members of the management team have developed strong views about a course of action, and this is one reason why it is important for the board to be involved early.
- **Take care with lock-ups and defensive measures.** The board should consider whether deal protection terms, and in hostile

situations, defensive measures, are reasonable given the threat presented.



Search [Defending Against Hostile Takeovers](#) for more on the purpose and structure of various takeover defenses.

- **Ensure that directors are aware of their duty to maintain strict confidentiality.** Directors are required to keep confidential all information they become aware of as directors. The fact that a company is seriously considering or has initiated or received an approach to do an M&A deal constitutes highly sensitive information that must be kept confidential until the time is ripe for disclosure. Protection of confidentiality also extends to boardroom discussions and director deliberations.
- **Understand deal structure, motivations and terms.** The board should understand why management seeks to pursue (or oppose) a transaction, the important aspects of the transaction (strategic as well as financial) and why a particular deal structure has been chosen (for example, merger, tender offer, asset purchase or sale). Terms should be checked to see how they compare against current market practice (for example, the size of any termination fee). Other than price, these terms should include how the transaction will be financed, closing conditions, deal protections and buyer walk-away rights.
- **Retain independent advisors as necessary.** Information and advice is the predicate for informed decision-making. The board should retain experts as appropriate to ensure that the board has the information it needs to make decisions in the best interests of the company.
- **Understand and attend to director and management conflicts.** Conflicts of interest not only may lead to less than optimal deal terms, they may also lead to heightened levels of scrutiny by the courts when a deal is challenged. The board should understand financial and other incentives that management or certain directors may have that could cause them to advocate for a particular outcome. Conflicts may include:
 - an interest in continued employment or a position;
 - a severance payment upon a change in control;
 - a reputational interest in leading a larger entity; or

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- interest in a management buyout of a piece of the company after the deal has closed.

■ **Understand and attend to financial advisor conflicts.**

The board should understand the interests of its advisors, including actual and potential relationships between its financial advisor and potential bidders. The board should review the financial advisor’s engagement letter, which should discuss the advisor’s role and any conflicts, the circumstances (if any) under which the advisor may approach potential bidders and others about a potential deal, and expectations around ongoing communication with the board as discussions with potential bidders evolve, as well as other customary provisions. Special care is needed when a financial advisor:

- is involved on both sides of the transaction (whether as an advisor or a provider of financing);
- holds stock in either or both of the participating companies; or
- is incentivized to pursue a particular deal at the expense of other deals.

■ **Consider whether special steps are needed to ensure an independent process.**

The board should discuss with corporate counsel whether it should retain its own counsel to advise on the identification and management of conflicts and other issues related to the process for decision-making, including whether retaining an independent financial advisor would be prudent and whether the board should consider delegating to a special committee responsibility for negotiating the deal. The board should consider appointing a special committee of independent and disinterested directors to evaluate the transaction on an arm’s-length basis and vigorously negotiate on behalf of the company in situations where:

- directors have real or potential conflicts of interest;
- there is a concern that the board may be viewed as controlled by an interested party (for example, a controlling shareholder in a buyout situation);
- management has significant conflicts (for example, during a management buyout); or
- oversight of a complex transaction may be more efficiently handled by a smaller group.

■ **If a special committee is formed, ensure that it has a formal charter.**

The charter should define the scope of the committee’s authority and the right to hire independent advisors. Counsel should advise on the scope of the committee’s charter, composition and processes to make it more likely that the actions or decisions of the special committee will receive the benefit of judicial deference.



Search [Making Good Use of Special Committees](#) for more on when a special committee is needed and how to conduct a proper process.

■ **Focus on and test assumptions about value.**

The board should carefully review analyses prepared by management and financial advisors about how much value a deal will add and to verify key assumptions inherent in the analyses. Unfortunately, when judged with the benefit of hindsight, M&A transactions

often fail to add shareholder value, whether due to overly optimistic management projections about the competitive impact or the synergies to be realized, unduly high costs or poor integration. The board should consider whether a market check should be undertaken. Canvassing the market is prudent where real or potential conflicts are present but may not be necessary, for example, where the board is extremely knowledgeable about the company and its industry, and is not conflicted.

■ **Understand who is negotiating and the parameters of the negotiations.**

Deal negotiations on behalf of the company should be led by a person who lacks conflicts. Independent M&A counsel should be retained to advise on deal structure, terms and other issues where appropriate (such as a transaction involving an affiliate or where management is otherwise conflicted). Other advisors, such as technical experts, should also be retained where appropriate. The board should provide oversight of the negotiation process and clear directions on an ongoing basis as to the negotiator’s mandate, including which deal terms can and cannot be accepted without further negotiation (for example, price per share).

■ **Create a contemporaneous written record.**

The Delaware courts continue to emphasize the importance of minutes and other contemporaneous written records of the board’s consideration of an M&A transaction. These records will be given significant evidentiary weight in a litigation challenging the actions of the board, and due care should be taken regarding the written record.

■ **Oversee corporate disclosures.**

Corporate communications in the M&A context should, as always, be coordinated through the senior executive team and approved as appropriate by the board. In most cases, the CEO will lead communication efforts, but in certain circumstances an independent chairman or lead director may be involved (for example, if the CEO is conflicted). Each director should be reminded that all queries about the deal are to be directed to the official communication channels, to ensure delivery of a consistent message and lower the risk of noncompliant disclosures. The board should review important disclosures about the deal, such as the press release, proxy statement and tender offer documents.

■ **Engage with target company shareholders.**

The shareholders of the target company will decide for themselves whether to approve a deal, either through approval of a merger agreement at a shareholder meeting or by tendering shares into a tender offer. Shareholder communication by the target company board should help shareholders understand the target board’s reasons for approving or rejecting a deal. For shareholders faced with a hostile offer, an offer may seem attractive purely because it is priced above the prevailing market price, even though the offer price may be inadequate from a company valuation perspective. The target company’s board can help overcome this collective action problem by recommending that shareholders reject the offer and explaining why it believes the deal is undervalued.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.