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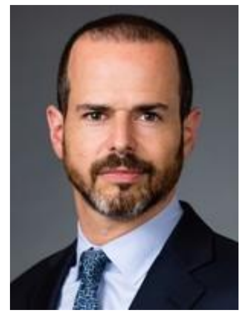
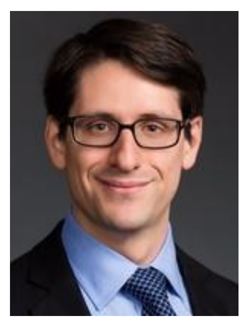
10 Tips For Managing Litigation Risk In Sell-Side M&A

By **John Pollack, Adam Offenhartz and Daniel Alterbaum**
December 13, 2017, 12:08 PM EST


John Pollack


Adam Offenhartz


Daniel Alterbaum

For mergers and acquisitions lawyers, sell-side representation is particularly rewarding. The client is focused on achieving a desired outcome, usually there's solid interest from one or more bidders for the target business, and the parties are ready, willing and able to commit the resources to consummating a transaction. While it is, of course, important to focus on "getting the deal done," a seller should also take into account and plan for potential deal litigation. If the client is a public company contemplating a sale-of-control transaction, the client needs to appreciate that shareholder litigation is very likely — indeed, a savvy seller should plan and run its process as if litigation is inevitable. If the client is a private company with shareholders with divergent views on the sale, litigation is also a real possibility. In either situation, a seller should keep the following considerations in mind.

1. Hire Experienced Legal and Financial Advisers

Now is not the time to hire someone's brother-in-law who runs a small investment bank or a general law practice that has little experience with the ins and outs of M&A. Courts have expressed concern when the seller's advisers appear overmatched by those of the buyer. After all, the seller will need to rely on its advisers' expertise and insights in order to achieve the best price reasonably attainable for the target business, as well as to succeed in the courtroom. Chief Justice Leo Strine Jr. of the Delaware Supreme Court memorably described this mismatch as a "DANGER SIGNAL, akin to the one at Niagara about the approaching falls. You don't guard Dwight Howard with Nate Robinson — however much you enjoyed their teamwork in the NBA slam dunk contest a few years ago. If independent directors get weak advisors, they will screw up."[1]

2. Run a Careful and Thorough Process and Maintain a Good Record

Process matters in sale-of-control transactions. The board (or any necessary committee of the board) of the seller should meet regularly, be well-informed and ask questions. The board can and should rely on its advisers and management, but should not act as a rubber stamp. An informed and engaged board, and a record that reflects such appropriate board involvement, is the goal and goes a long way toward establishing that the board fulfilled its fiduciary duties.

3. The Judicial Standard of Review Matters

In Delaware, the standard of review applied by a court when scrutinizing a transaction is of great importance. If the "business judgment rule" applies, the court will presume that the board acted in an informed manner, in good faith and with the belief that their actions were in the best interests of the company and its equity holders. A touchstone of the rule is that the court will not second-guess the judgment of the board so long as the board's decision can be attributed to "any rationale business purpose." Different aspects of a deal — for example, when a large stockholder is involved on both sides of the transaction — may require the seller to create an independent committee to handle the sale process and predicate the deal on certain voting results being obtained, for example. Taking such steps may help the seller avoid a more stringent standard of review or at least shift the burden of proof. While a seller can prevail entirely or reach a constructive settlement in shareholder litigation in the face of a more stringent standard of review, it will generally be a more difficult and expensive path.

4. Vet Conflicts Early and Again

It is important to identify potential conflicts in the sales process as soon as possible. Such conflicts can take a variety of forms, such as an interested stockholder transaction (which typically occurs when the seller's controlling equity holder is also the buyer) or the seller's investment bank has a material relationship with the potential buyer. The former will necessitate the use of a special committee of disinterested directors and other mechanisms to best position the seller in any shareholder litigation (as discussed above). The latter is more readily navigable and can usually be addressed by ensuring that such relationship is disclosed to the board early in the process so that the board can make an informed decision whether to engage the investment bank (and perhaps to even engage a second investment bank as well). Since conflicts can arise at any time, a careful seller, out of an abundance of caution, will want to inquire about conflicts periodically during the sale process. Outside counsel is essential for analyzing the risks raised by an array of potential conflicts and for identifying potential solutions.

5. Management Plays an Important Role

The cooperation and focus of senior management in the sales process is critical. They play an important role in the marketing of the target business, the due diligence process and the drafting and negotiation of the purchase agreement and related disclosure schedules. Without sufficient management help, the sale process can be delayed or derailed. In addition, the board and its advisers need to ensure that the members of target management are acting as fiduciaries during the sales process and not improperly assisting the buyer. Similarly, the board must take care in determining the role, if any, for senior managers (and directors) who may be joining the buyer and related matters.

6. Don't Overlook Confidentiality Agreements

Because confidentiality agreements are often the first step in the sales process, and it's not unusual for many of them to be negotiated at the same time in an auction, their importance may be overlooked. These agreements contain provisions that, with 20/20 hindsight, can be critical to managing a good sales process. Examples include (1) a restriction on forming a consortium, which ensures that the seller board has control over which auction participants work together (if any), (2) a provision that prevents the bidder from locking up debt financing sources through exclusivity arrangements (to help ensure adequate sources of debt financing remain available to other bidders), and (3) a standstill provision, which restricts bidders from side-stepping the sales process and launching public offers, thereby allowing the seller board to maintain control of the process.

7. Don't Reveal All in Diligence Prematurely

Sellers are often eager to expedite the diligence process in order to get to the closing table as quickly as possible. Such sellers will not want to stagger the disclosure of diligence material in stages, but rather will want to make all relevant information in the data room available straightaway. However, before material nonpublic information is made available to bidders, sellers should give their counsel reasonable time to review the disclosure materials from a confidentiality and antitrust perspective, among others. Certain information may be subject to restrictions on disclosure (as a result of other confidentiality agreements, for example) that need to be navigated. Depending on the transaction and parties involved, the sharing of certain information may require the use of "clean rooms" and other mechanisms to comply with antitrust law. In addition, it's important that seller and management be mindful ahead of time (before sell-side marketing materials are prepared) that if a deal gets signed where notification is required to be made under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, all "Item 4(c)" documents (which, generally speaking, are documents that speak as to the competitive impact of the transaction) must be filed with relevant antitrust authorities. Sellers, and often their financial advisers, need guidance so they can avoid inadvertently creating problems with respect to antitrust approval.

8. Be Mindful of "What's Market" on Deal Terms

In our experience, seller boards on public company transactions usually want to agree to "market terms" (or better, from the seller's perspective) for a number of reasons, including that "what's market" has been tested in practice and to best position themselves in deal litigation. But some deals may require terms that are not market, and there's nothing inherently wrong with that. What's critical on the sell-side is ensuring that the advisers have reviewed such terms and the seller board makes an informed decision as to how they may play out in practice and in litigation.

9. On Private Sales with Private Equity Sellers, Push for "No Survival"

The seller's representations and warranties are a heavily negotiated and central provision in a private sale of a company (in contrast to public deals, where the R&W typically do not survive the closing of the transaction). Such provisions can leave the seller with ongoing liability for breaches of the R&W and are a frequent basis for litigation in private sales. Financial sponsors pursuing private sales are increasingly trying to avoid or lessen this exposure by negotiating for buyers to rely on a R&W insurance policy for recourse above a retention amount. This normally means either a "no survival" deal (as in a public company sale) or one with limited survival where the seller's post-closing exposure is capped at an amount held in escrow, often an amount tied to a negotiated sharing of the retention amount (e.g., 50/50 sharing, where the escrow equals 50 percent of the R&W insurance retention). By minimizing exposure for post-closing recourse, the private company seller reduces the risk of indemnity-related litigation brought by the buyer (though it remains possible that the buyer will retain the right to bring claims for fraud).

10. Don't Wait Until Litigation to Involve Your Litigator

Some sellers and their M&A advisers make the mistake of waiting until a shareholder complaint has been filed to involve litigators. The better practice, though, is to involve litigators as the sale process is beginning. The litigator can join their corporate colleagues in advising the seller on a range of issues (including potential conflicts, guidelines for avoiding inadvertently distorting the record, standards of review, document preservation, privilege issues, and a variety of other issues).

John M. Pollack and Adam H. Offenhartz are partners and Daniel S. Alterbaum is an associate attorney at Gibson, Dunn & Crutcher LLP in the firm's New York office.

[1] Leo E. Strine, Jr., Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-making and Reduce the Litigation Target Zone, Business Lawyer, Summer 2015, at 686.