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Risk Management in M&A Transactions

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Directors of acquiring companies in M&A transactions are well served by demanding more extensive reporting to the Board regarding risks associated with the target company's business and the acquisition, including an evaluation of the target's risk identification and management processes. This assessment can be a meaningful barometer of the potential for unexpected issues to arise, which helps protect the company and directors from claims while maximizing shareholder value. However, completing such an assessment bears its own difficulties.

Transactions are often conducted quickly. Management faces challenges in obtaining risk-related information during an acquisition. Targets are not always forthcoming about the management of risks facing their business. Information shared is frequently "sugar-coated," and can downplay the probability and magnitude of potential risk, or oversell the effectiveness of risk management processes. Furthermore, management championing a transaction may underestimate the risks of the acquisition and of the target's business, or assume that directors are already aware of the risks facing companies within the industry of the acquirer. It is the director's job to ask skeptical and penetrating questions of management and advisors, particularly during a major business decision such as an acquisition. Here are important questions to ask when your company is considering an acquisition:

1. What is the target company's existing risk management infrastructure?

A starting point is obtaining a detailed picture of the target's enterprise risk identification and management infrastructure. This includes understanding the target's risk management process, how it was constructed and how it works as a process, whether or not those target team members responsible for risk management are able to ensure that awareness of material risks is shared with appropriate decision makers, and how frequently and recently a risk identification exercise has occurred. Only if the acquirer is satisfied with the target's internal risk management process can it begin to reasonably rely on the target's assessment of risk management issues. If the target cannot provide evidence supporting the maintenance of a comprehensive and dynamic risk management process, a more searching review of potential risks facing the target is likely to be necessary.

2. What is the ability of the target company's business to withstand unexpected economic pressure?

A time of economic uncertainty suggests particular aggressiveness in running "stress tests" on assumptions regarding a target's resilience and growth prospects. Think through and analyze how the target company will handle large shifts in demand, its sensitivity to interest rate changes or currency fluctuation, and other macro-economic drivers of the target's prospects. In addition, consider whether any disruptive events are expected in the target's industry. For example, are

competitors introducing a new technology? Is new regulation planned? How is the general operational landscape changing for companies in the relevant industry or for other similarly-situated companies in terms of size, geography or dependencies?

3. How thoroughly has the acquiring company's management reviewed the risks affecting the target's business?
Even if the target company appears excellent at conducting enterprise risk management, it remains important to ensure that the acquiring company's management has undergone an independent, systematic and robust risk review to validate compliance and integrity. A Board can request reports from management on their analysis of the risks associated with the target businesses and demand that those reports reflect thorough and thoughtful analysis.

4. What are the potential pressures on various types of expected synergies?
Carefully analyze potential synergies and other integration issues in light of economic conditions, potentially expanding the “worst case” scenarios. While overhead reduction may be easier to achieve during a down cycle, reductions in variable costs, such as due to increased scale in sourcing may be more difficult to achieve when business is down. How much downward pressure can the assumed synergies handle before the deal loses its economic value at the purchase price under consideration? In all areas – be they financial, commercial, regulatory or cultural – assess the implications of current demanding and foreseeable future economic conditions.

5. What are the potential risks of the transaction itself?
Receive confirmation that the team has sufficiently diligenced the potential risks that the deal execution itself may trigger. Does the Board understand regulatory approval risks associated with the industry in which the acquirer or target operate? Will the combination of the two companies cause customer defections because of competitive concerns? Are the intellectual property licenses or other supply sources at risk of being lost because of a merger? Will a merger trigger any restrictive covenants in financing agreements on either side? Be confident that a thorough review of the potential consequences of a transaction have been considered in every arena of the business.

6. Do the transaction terms include risk mitigating features?
Acquirers can negotiate deal terms that protect the acquirer from potential acquisition risks. Seek representations and warranties as to risk management matters such as internal controls and Federal Corrupt Practices Act compliance. Insist on pre-closing information rights where they pose no conflict with antitrust compliance. Allow for contractual "outs" for the acquirer when certain risks materialize before closing (above and beyond a material adverse condition clause). Use purchase price features to allow for the price to be adjusted if the target's financial position changes between signing and closing. Designate some part of the acquisition price as a contingent "earn-out" subject to benchmarks being achieved after closing, while allowing sufficient post-closing operational flexibility. In a private company acquisition, an escrow can set aside a portion of the consideration to indemnify against any risks as to which the target has made representations.

7. Has the company involved independent expertise regarding the target's business and the acquisition process generally?
If the target's business is outside the area of the acquiring Board's expertise, the Board may wish to consider retention of outside advisers or management with significant expertise or expansion of the Board to include a director with experience operating in the target's business. Having someone with

independent expertise in the target's industry or in acquisition transactions involved in decision-making can be important to ensuring that expectations will be realized in the results.

These questions and others should be considered and analyzed by management, under the direction of the Board, early in the process and in a systematic way. It is essential that an appropriate record of the consideration and analysis be kept in the acquiring company's Board minutes, consistent with good corporate recordkeeping practices. This type of contemporary, documentary evidence of the Board's activities can help to accurately reflect the Board's oversight activity and informed decision-making, which will serve to protect directors in the event of a later claim alleging that the directors breached their fiduciary duties in connection with a transaction.

As M&A activity and general transactional activity accelerates in the latter half of 2009, directors and general counsels would be well advised to prepare management for a robust risk identification and management process in connection with future transactions. In addition to liability prevention, it is simply good for business and maximizing shareholder value.

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