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Guidance for Boards of Public Company M&A Targets

From the Experts

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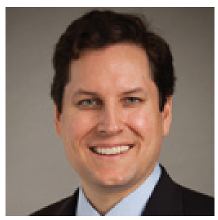
In connection with a sale of the company, the board of directors of the target faces the formidable task of discharging its fiduciary duties to its stockholders in a context in which the board's actions are likely to be scrutinized in subsequent litigation. The following article provides guidance to target boards, and the lawyers who advise them, in the public M&A context on topics that the Delaware courts have recently considered.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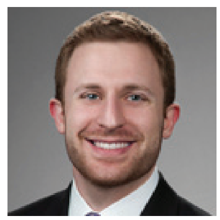
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Conflicts Of Interest

In any M&A transaction, a target board must be mindful of conflicts of interest affecting directors, the chief executive officer, and the board's financial advisor. The clearest conflict arises where one of these participants holds an ownership or other business interest in the acquiring entity or any of its affiliates.

To address these conflicts, and conflicts generally, the board should:

• Identify and understand the conflicts at the outset of the transaction. For example, the board should address all potential conflicts at the first board meeting where it considers a bid.

• Avoid or mitigate identified conflicts. For example, the board may need to create and empower a special committee of disinterested directors, retain an independent, thirdparty financial advisor, or remove the CEO from negotiations to address the particular conflict.

• Monitor for emerging conflicts continuously throughout the transaction.

• Document in the minutes of the board every effort to identify, understand, and address conflicts, including explanations for permitting any potential conflicts.

• Disclose conflicts to stockholders.

Conflicts of interest may arise with respect to the CEO of the target company where the CEO, commonly the target company's lead negotiator, will benefit from future business deals or employment with the acquiring entity. To mitigate these conflicts, the target board should direct the CEO to seek guidance promptly from the board regarding any incipient M&A negotiations and, to the extent possible, refrain from discussions with the buyer involving management retention until after the parties have agreed to the fundamental terms of the deal, such as price.

In addition, conflicts of interest may arise with respect to the financial advisor of the target company where the advisor's compensation that is contingent upon closing the transaction could be viewed as creating an incentive for the advisor to favor that transaction when the advisor renders its fairness opinion regarding the deal. Courts have required target boards to disclose to stockholders the existence of the contingent fee and, where the contingent portion of the overall fee exceeded customary levels, the amount of the contingent fee.

A target company's financial advisor may have extensive contacts in the target's industry and have been engaged on prior assignments by likely bidders (indeed, these contacts may be one of the primary reasons the target board hired the financial advisor). Prior to engaging the financial advisor, the target board should gather information about the financial advisor's services provided to, and compensation received from, likely bidders, along with other information that would be helpful to determine the existence of potential conflicts of interest, and evaluate whether a potential conflict exists.

The safeguards that a board takes to mitigate a conflict of interest can affect the level of scrutiny with which courts will review target-board decisions. Consider, for example, the sellside conflict of interest that can arise where a controlling stockholder seeks to acquire the target company, in which case there may be a risk that the controlling stockholder will unduly influence the board to approve a merger on terms unfair to the minority stockholders. The Delaware Court of Chancery, in a recent decision, applied for the first time the deferential business judgment rule, instead of the more exacting entire fairness review, to a merger where the acquirer was the controlling stockholder of the target. The court applied the deferential standard of review because the transaction, from the outset, was conditioned upon approval by an empowered, independent committee of directors and by a majority of the shares held by minority stockholders. *See In re MFW* (2013).

Likewise, the Delaware Court of Chancery recently applied the same deferential standard of review to a merger where the acquirer was a third party and the controlling stockholder of the target rolled over a portion of his shares into the merged entity. The court again applied the deferential standard because the transaction was similarly conditioned upon approval by an empowered, independent committee of directors and by a majority of the shares held by minority stockholders. *See SEPTA v. Volgenau* (2013). In light of these decisions, boards of target companies with controlling stockholders should be mindful of these procedural safeguards when implementing a process to consider an acquisition proposal from the controlling stockholder.

Single-Bidder Negotiations

Delaware courts have also recently considered whether a target board has satisfied its fiduciary duties to stockholders in situations in which the board negotiates with only one potential buyer before executing the definitive agreement. In appropriate circumstances, courts have held that a targetcompany board can satisfy its duty to obtain the highest price reasonably available even if the target negotiated with only a single bidder. Specifically, courts scrutinize such "singlebidder sales" to ensure that the sale, taken as whole, results in a process reasonably designed to maximize the price for target stockholders. To withstand such scrutiny, the board should ensure that it has sufficient business and financial expertise, experience with similar M&A negotiations, knowledge of the relevant market, and a body of reliable evidence with which to evaluate the single-bidder sale. In this regard, the board should refrain from placing undue reliance on a fairness opinion from its financial advisor because courts have repeatedly referred to advice from financial advisors as a "pale substitute" for a market check.

The board should also, where possible, negotiate the definitive agreement to include provisions that, in the aggregate, constitute a de facto post-signing market check. For example, the definitive agreement may provide for a modest termination fee that would not preclude topping bids and for sufficient time between signing and closing to expose the proposed transaction to the market. Similarly, the definitive agreement may contain mild deal-protection provisions and a flexible fiduciary-out clause through which the target board could pursue topping bids. To the extent more fulsome dealprotection provisions find their way into the definitive agreement, the board should document its efforts to extract further consideration in exchange for their inclusion.

Standstill Provisions

Delaware courts have also given significant attention to the impact that standstill provisions, and in particular so-called "don't ask don't waive" standstills, have on a target board's ability to discharge its fiduciary duty to obtain the highest price. Targets engaging in an auction process commonly include in confidentiality agreements such standstills, which prohibit bidders from submitting bids without the target's permission and even from asking the target to waive such prohibitions.

On the one hand, courts have acknowledged that such standstills can maximize value for stockholders by forcing bidders to present their best price during the auction and according finality to the auction process. On the other hand, recent cases suggest that such standstills may be subject to increasing judicial scrutiny out of concern that they can create a postauction information vacuum, impermissibly limiting the board's ability to evaluate competing offers, disclose material information, and make a meaningful recommendation to stockholders.

The board may consider incentivizing bidders to present their best price at the auction by promising up front to assign the standstills to the winning bidder or to include a nowaiver clause in the definitive agreement. Alternatively, the board could decide to include standstills in confidentiality agreements with bidders but then waive the standstills upon entry into a definitive agreement in order to allow for additional bids.

In all cases, the board should document its careful consideration and comprehension of the standstills, and the board should fully disclose the standstills and their effects to stockholders. The board should also be mindful that the combination of a broad noshop provision in the definitive agreement with the standstill (preventing once-interested bidders from expressing continued interest) can create the kind of "informational vacuum" that disconcerts courts.

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