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REPORT

Mergers and Acquisitions

Protective Pre-Acquisition Measures Key For Boards of Companies Looking to Expand

■ ***Practice Tip:*** *Boards of public companies that may be involved in a merger or acquisition in the near future should have in place a robust set of pre-acquisition due diligence practices to protect the organization from the new risks that have emerged in the M&A market.*

In light of the growing involvement of many public companies in domestic and overseas mergers and acquisitions, the boards of such organizations should have in place effective pre-acquisition due diligence practices to shield their companies from new risks, business transaction attorneys told BNA in recent interviews.

Many companies emerging from the down economy are looking for new ways to grow by focusing on emerging global markets, Homer E. Moyer Jr., an international law attorney who specializes in Foreign Corrupt Practices Act issues at the Washington office of Miller & Chevalier Chartered, told BNA May 31. In order to reduce the new risks associated with global expansion, corporate boards should conduct thorough, targeted pre-acquisition due diligence activities, he said.

Board decisions in public and private deals continue to be scrutinized heavily, Edwin D. Mason, a partner and co-chair of the business law department at Foley & Lardner LLP in Chicago, told BNA May 31. Directors—on both the acquiring and selling sides of a merger or acquisition—need to be mindful of their duties of care and loyalty, he said.

In the current economy, shareholders are increasingly filing complaints against directors for breaches of fiduciary duties in connection with the directors' management of potential purchasers' bids for their companies, according to a June 16 White & Case LLP client alert. These complaints are often filed along with claims against bidders, purchasers, and majority shareholders for aiding and abetting the alleged fiduciary breaches of directors, the alert said.

Global Expansion Efforts Usher in Risks. The recent increase in global expansion efforts on behalf of many companies can expose these organizations to numerous new risks—especially corruption issues resulting from overseas acquisitions, according to Moyer.

There has been a steep upward trend over the last five to ten years of FCPA enforcement activity in the United States, Moyer said. This trend is accompanied with an increase in penalties, case load, and prosecutions of individuals, he said.

Key Director Due Diligence Activities.

Edwin D. Mason, a partner and co-chair of the business law department at Foley & Lardner LLP in Chicago, told BNA May 31 that board members of companies that may be involved in a merger or acquisition in the near future should, among other practices, exercise the following due diligence activities to ensure a successful acquisition:

- Instill a strong comprehension of the duties of due diligence and loyalty among all directors;
- Evaluate the strategic and cultural fit of the target company to ensure it complements the organization;
- Assess the expected rate of return of the acquisition to ensure proper structuring of the transaction;
- Perform a realistic appraisal of the target company's investment, return, and prospects; and
- Develop a clear post-transaction plan.

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''If a company and its board members do not engage in meaningful pre-closing due diligence activities that include a substantial FCPA component, they may be subjecting themselves to enforcement action,'' Moyer said. Unfortunately, pre-acquisition due diligence activities are not currently a high priority on many board members' radars, he said.

According to Moyer, the new risks posed by overseas M&As are not as widely appreciated by many boards as they should be, because FCPA enforcement actions have only recently begun to see such a dramatic increase.

Moreover, M&A risks are emerging that would not have been as significant or apparent 10 or 15 years ago, Moyer said. ''Specifically, one of the most significant risks is successor liability—where the acquiring company in an acquisition potentially becomes legally liable for past violations of the company it is acquiring. This is a major risk that can affect companies involved in overseas or domestic acquisitions,'' he said.

Due Diligence Key Before Acquiring Company. More and more boards have been expanding their due diligence activities to include a process that specifically addresses key FCPA components, Moyer said. ''In fact, an increasing number of boards and their audit committees are actively involving themselves in this process,'' he said.

It is crucial that board members keep an eye out for new risks—which would be unique to each transaction—as they will affect the reputation of the organization, as well as lead to litigation filed by a company's shareholders—which usually happens after FCPA violations are announced, Moyer said.

''FCPA due diligence is an absolute necessity because enforcement officials have high expectations, and the consequences have become much harsher. This cannot be an after-thought,'' Moyer said.

According to Mason, ''while M&A transactions are being scrutinized by the courts, the fundamental framework of fiduciary duties have been left essentially unchanged,'' he said. ''The Delaware courts have confirmed this. They have determined that if board decisions are made in good faith by disinterested directors exercising the proper duty of care, the courts will refrain from judicially second-guessing their business judgements,'' he said.

M&A Activity Growing, But Still Struggling. In 2010, there has been some increase in both the volume and size of deals being performed following the gradual recovery of the financial markets, Mason said. However, the increase in M&As has not been up to the levels that preceded the economic downtown, he said.

Looking forward, hostile activity—including enforcement and litigation—related to M&As is expected to remain high, Mason said.

''Even with the uptick in M&As in 2010, buyers are guardedly optimistic about the economy and growth in general. They are definitely taking the time to ensure their deals make sense from a business perspective,'' Mason said. ''These buyers are exercising due diligence by, among other activities, assessing the risks,'' he said.

''Now, we are seeing that more corporate development teams of acquiring companies are increasingly coordinated to work on the business side in assessing the economics of transactions,'' Mason said.

''They are also working with outside advisors—principally, attorneys, accountants, and investment bankers—as a comprehensive team to understand all the nuances of a transaction to ultimately structure the deal appropriately,'' Mason said.

Different corporations will have their corporate development teams perform M&A-related tasks differently, Mason said. Some will have the teams perform pre-acquisition activities, and then have them intensively involved with post-closing integration activities, he said.

Aiding and Abetting Is Major Risk. In today's volatile stock market, shareholders are acutely focused on the timing of the board's decision to sell the company, particularly if share prices are below historic highs, the White & Case alert said.

Shareholder suits against boards of directors for breaches of fiduciary duties in connection with the directors' management of potential purchasers' bids for their companies is not new, the alert said.

The problem is, ''Purchasers can protect themselves from such claims by negotiating with the target board solely on an arm's-length basis, but when purchasers begin to offer disproportionate consideration to individual members of the target board or executive officers, aiding and abetting liability becomes a palpable risk,'' the alert said.

According to the alert, to state a claim for aiding and abetting a breach of fiduciary duty in Delaware, a stockholder must allege four elements. These elements include:

- A fiduciary relationship must exist;
- The fiduciary's duty was breached;
- Defendants knowingly participated in the breach; and
- The breach caused damages.

'Knowing Participation' Not Precisely Defined. The courts have failed to develop a bright-line rule to determine when a purchaser ''knowingly participates'' in a fiduciary's breach, the alert said. ''Some general standards, though, have emerged. For example, courts find 'knowing participation' when the purchaser acts 'with the knowledge that the conduct advocated or assisted constitutes such a breach,' '' it said.

However, courts have consistently held that ''evidence of arm's-length negotiation with fiduciaries negate[s] a claim of aiding and abetting, because such evidence precludes a showing that defendants knowingly participated in a breach by the fiduciaries,'' the alert said. ''Determining when negotiations go beyond arm's-length, though, requires a fact-based analysis,'' it said.

''While the public policy rationale imbuing a target's board with fiduciary duties of care and loyalty to the company and its shareholders is well established, the rationale behind secondary liability for the aiding and abetting of a primary's breach of such duties is less clear,'' the alert said. ''Clearly a purchaser has the right to obtain the best deal it can negotiate, but when does it cross the line from negotiating a comprehensive deal with management to inducing management to breach their fiduciary duties?'' it said.

It remains to be seen whether the law will expand to include the ''secondary actor'' who, with no more than knowledge of a fiduciary breach, fails to correct a breach of fiduciary duty but continues to negotiate and close the transaction, the alert said.

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''For now, such a scenario would not likely lead to aiding and abetting liability. However, as the law of fiduciary duties continues to evolve, we may see that the safe harbor of negotiating at arm's-length may not always prove such a safe port,'' the alert said.

BY TINA CHI

The White & Case client alert is available at http://www.whitecase.com/files/Publication/a27235bb-5c42-4f36-8ef0-bad3eb128fd7/Presentation/PublicationAttachment/ea4da127-70b8-4efd-94e0-c3a2c2ce84eb/alert_MA_Buyer_Beware.pdf.