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The Board's Role in M&A

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Members of the board of directors of an acquiring company face a unique set of challenges and considerations through every stage of a transaction – from inception, to execution, through integration.[1]

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "The Board's Role in M&A" was a featured breakout session topic. The panel discussion was co-moderated by Steve Hilfinger, partner at Foley & Lardner, and James Nappo, managing director at UBS Securities LLC, and also featured John Baumann, general counsel of Steel Technologies, Inc.; Matthew Parr, managing director at UBS Securities LLC; and Ryan Urness, general counsel of Navarre Corporation.

Fiduciary Duties of a Board of Directors

When considering the duties of a director in the acquisition context, one must start with the basic fiduciary duties required of any director. The director owes the shareholders a duty of care, pursuant to which the director must make appropriate inquiries and obtain all reasonably available information in regard to a transaction. Second, the director owes a duty of loyalty. Deciding when the duty of loyalty is implicated is often the most difficult part, but a simple rule of thumb is that if a director has a chance for personal gain – as a result of either acting or failing to act – apart from the company's interest in a transaction, then the director should remove him or herself from consideration of the transaction. Common sense is the best guide.

The Role of the Board in Developing Investment Strategy

The board's level of involvement in developing an acquisition strategy can span the spectrum from minimally to highly engaged. If the potential target is smaller than the acquirer and familiar to it, the board of the acquirer may not have a high level of involvement in the transaction. However, the farther the target is from the "center of the fairway" in terms of its business model, the greater the scrutiny that should be directed toward the target by the acquiring board. In addition, the size of the company may affect the board's level of involvement. Multibillion dollar corporations may have entire departments devoted to seeking out and evaluating M&A targets, requiring less involvement by the board early in the process.

From the investment banker's perspective, a company whose board is engaged in the process of developing targets and is "plugged in" to the company's strategic goals is more likely to execute successful transactions. This high level of engagement manifests itself in

[1] The amount of case law addressing the particular duties of directors on the buy side of a transaction pales in comparison to the large number of cases addressing the duties of a target company's directors. One of the more influential Delaware cases focusing on buy-side duties is *Ash v. McCall*, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000). In *Ash*, the court refused to second-guess the good faith business judgment of a board which approved an acquisition based on expert advice and a thorough board process. The board action was challenged after the combined entity restated its earnings three times in the months following the closing. The board had hired a major accounting firm and global investment bank to assist in due diligence, and the court asked – what else could the board have done?

various ways. One example would be a board that engages investment bankers to help them realize "the art of the possible" by giving advice on strategy and the condition of the market even when there is no specific deal on the table.

While a board may occasionally identify an acquisition target, this is relatively uncommon. However, this should not discourage a company from selecting a director based on his or her particular expertise in the M&A realm. On occasion, the board may need to be more proactive in encouraging company management to pursue acquisitions.

That the board may have a limited role in identifying acquisition targets should not be much of a surprise – the board has a limited amount of time to meet, and usually serves a deliberative function in reaction to management's (hopefully proactive) leadership. In addition, the board's ever-increasing focus on compliance sometimes results in less time being devoted to developing ideas and strategies. According to the panel, there is a difference between a board providing oversight of management and a board micromanaging the day-to-day operations of a company. The worst case scenario is the board becoming too involved; the board should prod management, but not roll up its sleeves and do management's job. On the other hand, an acquisition is often a major endeavor to which significant corporate resources are devoted. Not getting the board involved at all would decrease the transaction's likelihood of success and would be inconsistent with the board's responsibilities.

Regardless of the level of involvement in the development of the acquisition, it is crucial that the board have a clearly articulated acquisition strategy and a process for reviewing that strategy – even if the strategy is to forsake M&A altogether. For instance, in the Caremark–CVS merger which has been the subject of recent litigation,[2] the board of Caremark had considered its M&A strategy and had decided that a "vertical" acquisition or combination (a purchaser of pharmaceuticals) may be beneficial. When the opportunity to merge with CVS arose, the board had an articulated strategy in place to support that merger as opposed to a competing "horizontal" proposal by a competitor. The case did not turn on whether the presence of that strategy protected the board, but it is something that may protect the board's decision-making in the future. The take-away: actions are more defensible if there is a visible process and strategy that a board can point to in support of those actions, and proper care is exercised.

Board's Role in Executing M&A Transactions

Once an acquisition target has been identified and the decision has been made to move forward with the transaction, the board's priorities shift to 1) understanding the proposed transaction and the information presented in furtherance of the transaction, and 2) being ready to act on that information.

[2] *Louisiana Municipal Police Employees' Retirement System v. Caremark*, C.A. No. 2635-N (Del. Ch. Feb. 23, 2007). Plaintiff shareholders and a competing bidder challenged a proposed "merger of equals" between CVS and Caremark on the basis that the Caremark board failed to consider other options and included onerous deal protections. The court delayed the merger vote when it found certain disclosures to be lacking, but did not reach the other substance of the complaint regarding the board's conduct.

The board should obtain information about the target and the transaction early and often. Gaining knowledge at the outset is beneficial because at that point the knowledge gap between management and the board may be more narrow; the board could be forced to play "catch up" if it waits too long to delve into the substance of the transaction. It is not uncommon for a board to appoint a special committee to consider a particular transaction that is large or complex and requires significant due diligence. In a company with high deal flow, a standing committee may be appropriate.

It is generally not the role of the board to establish guidelines or fence-posts for the economic terms of the deal; instead, the board should focus on understanding why the transaction is being proposed and reviewing the terms to ensure that they are consistent with the strategic goals of the company. There are disadvantages to allowing the board to become too involved in negotiating the terms of a deal. Early in the process, the board may be making decisions on the basis of imperfect information. For example, at the outset, the board may state that it will not bid more than a certain amount for the target. If the acquirer later discovers additional synergies that increase the value of the target, the board may find itself in an awkward position to justify a higher price.

The board's focus at this stage of the transaction should be on looking for red flags. It is not enough to have management bless the due diligence process – the board must not take management's word for it. Instead, the board should "drill down" into the information, and receive a report from the individuals who supervised the due diligence. It is easy for management to invest so much time in a transaction—or to "fall in love with the deal"—that it loses sight of the valuation of the target and industrial logic of the transaction. By obtaining information and asking questions, the board can add value, serve as a check on management and effectively represent the shareholders, even if that sometimes means slowing down the momentum of the deal. The board members also need to reach their own independent conclusions about valuation, and not blindly rely on management or the investment bankers.

Board Role in M&A Integration

By some measures, fifty percent of M&A transactions are not successful. Common reasons for this failure include: overpaying for the target, which places additional pressure on management; not fully understanding what is being purchased; and a clash of cultures between the two companies. The most tragic situation occurs when management and the board have properly identified an attractive target and executed the transaction well, but failed to plan for the integration of the two companies.

Not only does the board have a duty to oversee integration, but it is essential to the success of the transaction that an acquirer have a well-thought out integration plan for the first 100 days and beyond. This plan should be developed well ahead of the actual integration, and should be reviewed with the board. It should set forth milestones which must be reached within that initial 100 days. The plan should designate leaders and clearly define their roles and responsibilities post-closing, and may even contemplate the formation of an integration committee to help smooth the transition period. Consideration may be given to bringing in a third party to assist with or lead the integration process, if the advisor knows the business and the industry well and valuable time would not be wasted bringing the advisor up to speed.

Terminating M&A Transactions

A material adverse change is a very significant issue or change in the business which would provide justification for the purchaser to seek to terminate the transaction or adjust the purchase price. To constitute a material adverse change, the issue must result in a significant impact on the earning power of the target over a commercially reasonable time period. When it comes to determining whether a "material adverse change" has occurred and the deal should be terminated, the board (counseled by its advisors) should look objectively at the nature of the change and determine whether the change justifies termination of a transaction. Such terminations often result in litigation, including by the terminating party seeking declaratory relief.

Other Best Practices of Boards of Acquiring Companies

The board should communicate with the CEO to get information early and often. Directors should read the information that is provided. They should not just focus on the price and the information presented, but examine the deal as a business person and think about what is not being presented. They should challenge the assumptions behind the transaction, not just because it is the directors' fiduciary duty to do so but because they care about the company and its long-term success.

In addition, the board should be constantly asking itself whether it is appropriate to bring in third-party advisors. Board members presumably know the industry well, but they may have their own limitations and management is not always most qualified or able to perform due diligence. Third-party advisors can add value. At the same time, directors should not check their expertise at the door, and should act as a "reality check" on any advisors.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.