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The Board's Role in M&A

2008 NATIONAL DIRECTORS INSTITUTE

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INTRODUCTION

When a company is active in the mergers and acquisitions (M&A) market, its board of directors faces a unique set of challenges and considerations through every stage of a transaction — from inception to execution and through integration.

The seventh annual National Directors Institute, hosted by Foley & Lardner LLP on March 6, 2008, at the Four Seasons Hotel in Chicago, featured a panel of experts discussing the role of a board of directors in an M&A transaction. The panel was co-moderated by Bryan Armstrong of FD Ashton Partners; Justin Friesen of UBS Securities; and Foley Partner Steven Hilfinger. Featured panelists were Chris Brown of TechTeam Global and David Drury of Poblocki Sign Company. Following are the highlights of the panel discussion.

ANALYZING A BUY-SIDE TRANSACTION

The guiding principle for a board of directors in analyzing an acquisition opportunity must always be whether it fits well with the company's strategic plan. If the answer is "yes," then the board should dive deeper into the deal. It is crucial, however, to separate the threshold question of whether the transaction is a good strategic fit from the question of whether the target can be acquired at a favorable price.

Boards of highly acquisitive companies may institute "rules of engagement" to help guide their decision making as they explore acquisition opportunities. For example, the board could have a list of filter criteria (e.g., Is the transaction accretive? Does it enhance the pool of management talent?). If the transaction did not meet each criterion, it would not be approved. In addition, companies that are in high-growth industries or are otherwise acquisitive often have designated M&A committees, both to work with the CEO in reviewing and recommending transactions to the board as a whole and to serve as a dispassionate "speed bump" for the CEO. One study found that 25 percent of CEOs serve on such committees, a figure that seems to be conservative.

COMMUNICATION BETWEEN MANAGEMENT AND A BUY-SIDE BOARD OF DIRECTORS

When management takes an acquisition to the board of directors for consideration, the CEO should explain to the board how the proposed transaction furthers the company's strategy. Management must be thoughtful in choosing when to communicate with the board about the transaction. If management communicates too early, it can find itself handcuffed by the board and may risk wasting the board's time. Waiting too long, however, can mean there is insufficient oversight and can waste time and resources. One suggested rule of thumb is that the full board must meet and discuss a proposed transaction prior to the company entering into any letter of intent, including nonbinding letters.

From a board's perspective, it must seek to maintain its independence, avoid being a "rubber stamp" for management, and be willing to put the brakes on a deal if management is pushing it too fast without proper reflection or has otherwise "fallen in love" with it. At the same time, the board must avoid alienating management.

In any case, the CEO and the board frequently will communicate about pending transactions outside of formal board meetings. This allows the CEO to move issues along without formalizing the process, gives directors the opportunity to ask hard questions, and helps lay the groundwork for more formal considerations by the board. This activity is common and appropriate.

EVALUATION OF M&A IN THE CONTEXT OF CAPITAL ALLOCATION

In making decisions on how to allocate capital — whether weighing an acquisition against a share repurchase or reinvestment — the primary concern again should be whether or not the allocation of capital supports the company's strategy. Risk-adjusted decisions on acquisitions, including calculations of internal rate of return (IRR), often are more difficult to make than are decisions about whether to purchase a machine or build a plant.

DUE DILIGENCE

The level to which the board should examine the results of due diligence varies by transaction. In a transformational transaction, the board should really dig into the due diligence; in a "bolt-on" transaction, this is not as important. At board meetings where due diligence is being reviewed, it is helpful if the outside professionals who participated in the diligence can directly present their findings to the board unfiltered.

Although they remove some of the human element from the due diligence process, electronic data rooms have had the effect of putting all bidders on equal footing. From the sell-side perspective, a company should never launch a public process until it is fully prepared, with a well-populated data room and with key individuals prepared to answer the potential buyer's questions. Buyers should note that electronic data rooms allow the selling company and its advisers to monitor which individuals are looking at which documents, how frequently, and for how long. Sell-side investment bankers do track this information and frequently use it to determine which buyers are serious about their bids — particularly in a two-stage auction, where bidders are being selected to move to the second round. When one firm spends 10 hours in the data room and another spends 100 hours, the second firm may have an advantage in terms of being viewed as the more serious bidder.

KEYS TO BEING AN EFFECTIVE STRATEGIC BUYER

The key to being an effective strategic buyer begins with identifying acquisitions that fit within the company's strategy and remaining disciplined. When competing with a private equity bidder that has the ability to move very quickly in evaluating and completing a transaction, a strategic buyer needs to overcome this handicap in order to become an attractive buyer. The strategic buyer should mobilize as soon as possible by hiring advisers. As discussed previously, starting advisers on the due diligence process immediately might also help position the strategic buyer as a serious bidder. On the other hand, the strategic buyer does have natural advantages. Most important, it knows the industry and the current landscape in ways that private equity bidders and their advisers might not. This is especially helpful at the management presentation stage, when the level of questioning by a strategic buyer is often more in-depth.

BOARD ROLE IN M&A INTEGRATION

By some measures, 50 percent of M&A transactions are not successful. Poorly planned integration and weak cultural fit are commonly cited as factors in failed transactions. Indeed, if management cannot explain the integration strategy to the board prior to approval of the transaction, the board should view this as a red flag.

It is vital not only that the company have a written integration plan, but that it assign an executive to serve as integration manager and to coordinate the implementation of the plan. One recommended practice is for companies that make frequent acquisitions to have a template integration plan that can be customized quickly for each transaction. It is recommended that the board follow up on the progress of the integration plan every month for the first six to eight months after closing.

In a services company in particular, human resources integration — the merging of cultures and, often, of egos — is vital. One can never overemphasize the anxiety felt by employees of a target company, regardless of whether the acquirer is a strategic buyer or a private equity fund. And yet if the company is to be successful post-transaction, it will need those employees to buy into the new culture. It is important to provide easy access to information for employees, including a dedicated Web site where they can get answers to frequently asked questions.

Integration does not always mean the forcing together of two disparate cultures, however. For example, if the nature of the target company's business is tangential to the acquirer's, it may be beneficial to allow the acquired entity to retain its culture and remain somewhat distinct, under the leadership of its prior management. In this way, the culture that created an attractive target company will not be destroyed by the acquirer, with the resulting loss in value.

TRENDS IN M&A

An increasing number of high-profile transactions include "go shop" provisions, which require the board of directors to solicit alternative proposals from other bidders during the period between signing and closing a transaction. However, it should be noted that the Delaware Chancery Court has held that a board of directors violated its fiduciary duties, despite appointing a special committee and conducting a post-signing market check in accordance with the go shop provision, because it excluded strategic buyers from the market check.[1] The lesson is that courts are focusing not only on the process — in fact, there is no court-sanctioned process that will satisfy a board's duties in every transaction — but on the integrity of the process. The process must be "board-centric," and the playing field should not be tilted in favor of one buyer, although reasonable deal protection devices are, of course, appropriate and recommended.

In addition, one panelist noted that the tender offer has been revived in the past year as an acquisition tool. This has occurred as a result of a change in the U.S. Securities and Exchange Commission's (SEC) interpretation of the "best price" rule. The rule provides that a tender offer must provide all shareholders with the highest amount of consideration paid to any one shareholder. The SEC clarified that this rule applies only to consideration for the tendered securities, not to severance or other compensation received pursuant to the tender offer by shareholders who also happen to be management. This change increases the appeal and ease of the tender offer, which also offers the advantage of speed. A transaction effected by tender offer can close in as few as four to five weeks, compared with three to four months for proxy approval.

[1] *In re Netsmart Technologies, Inc. Shareholders Litigation* (Del. Ch. Mar. 14, 2007)

MORE INFORMATION

For more information on the topics discussed by the panel on “The Board’s Role in M&A,” please feel free to contact the panelists directly.

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