

M&A in the Boardroom

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On March 11, 2009, Foley & Lardner LLP presented “M&A in the Boardroom” as part of its National Directors Institute — 2009 Web Conference Series. Foley Partners Steven H. Hilfinger and Peter C. Underwood moderated the panel presentation. Other panelists included Walter (Bud) Aspatore, Co-Founder of Amherst Partners; Will Frame, Managing Director and head of the Paper, Plastics and Packaging practice at Deloitte Corporate Finance LLC; and Robin Johnson, Partner at Eversheds LLP. The panel discussed the role of the board of directors in formulating, evaluating, and pursuing acquisition or divestiture strategies in light of the unprecedented change in the financial markets. In addition, the presentation provided analysis of the current state of the mergers and acquisitions (M&A) and credit markets as well as certain legal issues and strategies for boards of directors to consider in relation to the current economic climate, including current trends in takeover defense measures.

The Current State of M&A Markets

In recent years prior to 2008, the M&A market was booming. M&A transactions often involved highly competitive auction processes, and sellers were generally considered to have the upper hand. Buyers typically lacked leverage and were often unsuccessful in negotiating extensive protections in transaction documents. This atmosphere drastically changed during the past 18 months. The United States and most of the world's other prominent economic powers are now in the midst of a severe recession. Consequently, M&A activity has decreased dramatically, down approximately 43 percent from the fourth quarter of 2007. This decrease, which has been largely driven by a lack of available credit, has shifted the power in M&A transactions from sellers to buyers. Buyers are now extremely cautious and are particularly focused on extensive financial and legal due diligence. Further, buyers are paying reduced prices and are successfully negotiating financing and due diligence outs, higher break-up fees, more favorable material adverse effect (MAE) or material adverse change (MAC) clauses, and contingent or deferred payment arrangements. The panelists expect these trends to continue in the near term.

The Current State of Financing Markets

The financial difficulties faced by lending institutions have been widely publicized. These difficulties have led to the demise of a number of the world's most prominent banks and an attitude of extreme lending conservatism on the part of the surviving banks. As a result, while mezzanine financing has increased, financing arrangements that were common prior to the fourth quarter of 2007, such as debt financing, have dramatically declined, resulting in a significant reduction in the general availability of credit.

In addition to the general difficulty in obtaining credit, those companies that are able to borrow are being presented with financing arrangements that are much less favorable to them than in the past. Borrowers have encountered an increase in the number and strictness of financial covenants, including interest coverage ratios and debt-to-EBITDA — or earnings before interest, taxes, depreciation and amortization — ratios. In addition, there are often higher prices and fees associated with new financing arrangements as well as a requirement that the amounts borrowed be guaranteed. Further, banks are now undertaking a more extensive due diligence review and are much more scrutinizing in their lending decisions.



The global economic recession also has significantly impacted companies with existing credit facilities. Many companies have breached various financial covenants contained in their credit facilities or have been forced to seek amendments to, or waivers of, those covenants to avoid a violation. Companies seeking such amendments or waivers have in many cases been forced to renegotiate their credit facilities, which often results in a greater number or tightening of restrictive financial covenants, significant fees, and an increase in interest rates. Even those borrowers who are not in imminent danger of violating financial covenants are facing up-pricing for added risk, limited access to LIBOR-based funds, and floors on interest rates.

Legal Strategies

Takeover Defenses

The global economic recession and the resulting significant decrease in the value of most companies' stock have created attractive targets for those companies that have cash available to finance acquisitions. Couple this decrease in share prices with the recent dismantling of takeover defenses caused by recent successful shareholder proposals and pressure from shareholder advisory groups, and, not surprisingly, the result has been a substantial increase in the number of hostile transactions since the fourth quarter of 2007.

To combat this trend, companies are implementing defense strategies to prepare themselves for a hostile proposal. These strategies include, among other things, putting into place a team and a plan to respond to a hostile proposal; carefully monitoring shareholder trading in the company's stock; and taking steps to get to know the company's shareholders and identify who among the company's shareholders are "friends" of the company. In addition, many companies, despite resistance from shareholder advisory groups, have turned to the traditional shareholder-rights agreement, or "poison pill," to help fend off a potential hostile proposal. In fact, year-over-year poison-pill adoptions increased in 2008 for the first time in more than five years. Many of the poison pills now being adopted include derivative positions in the definition of "beneficial ownership" and lower triggering thresholds.

Legal Issues in Distressed Sales

The panelists briefly discussed legal issues to be considered in connection with a sale of assets by a financially distressed company. In this context, the risk of a court determining that the conveyance was fraudulent is heightened because of the potential that the consideration received for the assets was inadequate or the seller was insolvent at the time of the sale. This risk may be mitigated by obtaining a fairness opinion with respect to the sale price and/or the existence of a balance sheet and cash flow projections that accurately portray the solvency of the seller. The panelists also briefly discussed sales pursuant to Article 9 of the Uniform Commercial Code and Section 363 of the United States Bankruptcy Code, noting that Article 9 is more appropriate for smaller transactions.

Board Strategies

In this time of economic difficulty — when companies' share prices are depressed, shareholders are unhappy and scrutinizing, and hostile proposals are prevalent — boards of directors of both public and private companies should bear in mind more than ever the fiduciary duties they owe to



shareholders. When called upon to approve an M&A transaction, particularly on the sell side, the board must undertake a thoughtful and informed decision-making process independent of outside influences. Further, it is the duty of the board to obtain the maximum price for shareholders, regardless of the financial peril of the company or pressure from management to approve a less-than-favorable offer. Directors' decisions will be heavily scrutinized by shareholders already upset by the decrease in value of their holdings.

Perhaps the best way to avoid shareholder litigation is to prevent a hostile proposal from being presented. In addition to the takeover defenses discussed above, this may be accomplished through diversification of a company's business. Companies that have less concentration in their customer and product bases and in their geographic footprint are less attractive acquisition targets. Boards of directors should encourage management to achieve greater diversification through internal initiatives as well as acquisitions. Assuming cash or financing is available, the current buyer's market presents a great opportunity for a company to diversify its business by acquiring a distressed or undervalued business. Alternatively, companies with available cash may wish to use that cash to ride out the recession.

For More Information

For more information on this session or Foley's National Directors Institute — 2009 Web Conference Series, visit Foley.com/ndi or contact the moderators and panelists directly.

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