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OPTIONS FOR DIRECTORS IN M&A LITIGATION

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EXPERT FORUM

OPTIONS FOR DIRECTORS IN M&A LITIGATION

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CD: Could you provide a brief overview of recent trends in litigation arising from M&A?

Welsh: Multijurisdictional litigation is an important evolving trend. In most deals, several plaintiffs' attorneys firms sue on the deal. They frequently sue both in the state where the target is incorporated, which is often Delaware, and the state where the target has its principal place of business. This has posed real challenges for closing transactions, and is a significant driver of pre-closing settlements. Recently, the Court of Chancery in Delaware has authorised corporations incorporated in that state to include, in their certificate of incorporation or by-laws, a provision essentially requiring all claims for breach of fiduciary duty to be brought in Delaware. This has the potential to curtail multijurisdictional suits. At the same time, however, it is not clear that charter provisions requiring forum in Delaware would be respected in all other jurisdictions and the Delaware Supreme Court could, at some point, reject these provisions. Delaware is also clamping down very recently on the amount of fees that plaintiffs' attorneys can earn in M&A suits. In several recent cases, the Delaware Court of Chancery has indicated that it intends to reduce the amount that plaintiffs' attorneys can earn for bringing makeweight M&A litigation. The combination of this trend, together with the increased adoption of corporate certificate or by-law provisions requiring suits to be brought in Delaware, may pose some impediments to frivolous M&A suits.

Goudiss: Today, every major public deal seems to be the target of a shareholder lawsuit, often within days of the transaction being announced. We also continue to see multi-venue litigation and it remains a challenge for M&A practitioners to have all the claims adjudicated in a single jurisdiction. While some recent decisions have sanctioned mandatory forum provisions in company by-laws, this approach does not seem to have been widely embraced. There have also been decisions addressing the merits of procedural mechanisms designed to protect the rights of minority shareholders, such as majority-of-the-minority votes, opt-out rights and special committees. In *In re MFW Shareholders Litigation*, the Delaware Chancery Court held that the business judgment rule applied in controlling stockholder mergers where both a 'properly empowered' independent special committee and an 'informed, uncoerced' majority of the minority stockholders approved the merger. This ruling, which is on appeal to the Delaware Supreme Court, was significant because previous decisions had held that application of either mechanism, as opposed to both, had only the effect of shifting the burden of persuasion to the plaintiff under the more stringent entire fairness standard. We expect to see even further developments as the Delaware courts are reconstituted.

Mordaunt: I continue to see a large number of cases involving earnout litigation. This has been a recurring portion of our work as financial experts for a number of years. However, we are seeing earnout provisions that are either very simplistic – for example, a portion of EBITDA without any specific definition – or some provisions that are fairly complex with many specific definitions and sample calculations. Also on the rise are breach of representations and warranties matters, typically brought forth by a buyer who is claiming it in essence did not get what it paid for. These cases involve wide ranging issues, such as sales or customer concerns, employee matters, environmental liabilities and contingent liabilities and often involve fraud claims. I have also seen an increase in shareholder derivative or dissenting shareholder actions in which the dispute revolves around the fairness of the price received by the seller. Lastly, as expected, working capital disputes are fairly common in deriving the adjusted purchase price subsequent to deal close.

CD: What types of M&A related claims are being brought against companies and/or their directors? What factors are fuelling these claims, and what differences arise depending on whether the directors are working for the buyer or seller in the litigation?

Goudiss: Sellers typically face shareholder lawsuits alleging breach of fiduciary duty by the company's board for failing to conduct a fair sales process – typically due to an alleged conflict of interest – and for failing to obtain a fair price for shareholders. Such suits often seek to enjoin the transaction based on alleged material omissions in the shareholder proxy. Often, the buyer is also named as a defendant, for aiding and abetting the alleged breaches by the seller's board. Factors driving these claims include allegedly coercive deal terms, potential conflicts of interests of the seller's directors, majority shareholder or financial advisers, disparity in treatment between the majority and minority shareholders, and inadequate disclosures in the proxy. Although rare, there have also been actions by shareholders of the buyer against the buyer board alleging breaches of fiduciary duty. These cases typically arise where there is a majority or dominant shareholder on both sides of the transaction, and are very rarely seen in third party deals.

Mordaunt: The second question dictates the answer to the first. For buyers of a company, we are predominantly seeing earnout related claims being brought against the acquiring company, though occasionally certain individuals responsible for negotiating the deal are also named. We also see working capital challenges being brought against the buyer shortly after deal close. Related to the seller,

the common types of claims brought against them are for breach of representations and warranties by the buyer, and shareholder derivative or dissenting shareholder matters brought by former shareholders of the business that was sold. In the shareholder-related claims, the former directors of the business are being individually named in many instances as they were the individuals responsible for consummating the transaction. We also see working capital claims brought by the buyer against the seller. In general, the factors influencing these claims are typically financially driven. In an earnout dispute, the seller believes they may be entitled to more than the buyer had determined, or that the actions of the buyer caused the earnout shortfall. In shareholder derivative or dissenting shareholder claims, these are brought by former shareholders who believe the company should have been sold for more. In breach of representation and warranty claims, the buyer believes it overpaid for the company due to the actions of the seller, magnified by the multiples placed on the value of the entity in deriving the purchase price.

Welsh: The principal theories continue to be, first, allegedly bad disclosure in SEC filings relating to the M&A deal and, second, the alleged failure of the target board to run a process designed to obtain the highest price reasonably available in the deal. These are common themes in most M&A lawsuits. In addition, conflicts of interest for the target's bankers continue be a hot-button, post-Del Monte. So do management conflicts – especially in deals with private equity buyers, in which management is often alleged to favour a financial buyer over strategic buyers because the financial buyer is more likely to retain management. So, too, 'liquidity conflict' claims – in which the plaintiff shareholders of a PE-backed or venture-backed target company allege that the company is being sold hastily in order to satisfy the liquidity needs of the PE or venture fund. Also, any transaction involving a controller or in which a significant shareholder – such as a shareholder with 'high vote' shares – receives differential consideration from the public shareholders attracts meaningful litigation. 'Don't ask/don't waive' provisions in standstill agreements have been successfully challenged in litigation recently. Recent

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Jeffrey J. Mordaunt, Stout Risius Ross, Inc.

decisions from courts, especially the Delaware Court of Chancery, taking these types of claims seriously are driving the trend.

CD: What types of M&A related claims are companies and/or their directors pursuing?

Mordaunt: This is in essence the opposite position to the prior question. From the seller's perspective, they are typically pursuing earnout and working capital claims against the buyer. From the buyer's perspective, they are pursuing breach of representation and warranty claims as well as working capital claims.

Goudiss: In rare cased, there may be post-closing claims by the buyer against the seller for alleged misrepresentations made during the course of negotiation of the transaction. There may also be claims for indemnification for breaches of representations and warranties. In the recent economic downturn and related credit crisis, there have been actions initiated by sellers for breach of the merger agreement, based on the failure of buyers to consummate the transaction due to the claimed inability to obtain financing for the proposed transaction. In such cases, the buyers claimed, unsuccessfully, that the collapse of the credit markets – or negative impacts on the target company's performance generally – constituted a material adverse event (MAE) that excused performance of their obligations under the merger agreement. There could also be strategic litigation by competing bidders.

CD: In some cases, actual or threatened litigation can prevent a merger or acquisition from completing. Is this a common result, in your experience? What other outcomes might be expected?

Welsh: Very few deals are prevented from closing on schedule and, when a deal is held up, typically, it is held up only briefly, usually for a couple weeks, to address a particular defect in the SEC disclosures or deal process, unless there is an alternative bidder. Other outcomes include settlement or potential post-closing damages litigation. Post-closing damages litigation is an important recent trend. Whereas previously, most M&A litigation was litigated exclusively pre-closing. The cases would either settle pre-closing, or the parties would litigate a request by the plaintiffs to enjoin the transaction, and if the plaintiffs lost, they would often abandon the litigation as not worth the costs of litigating. In the last couple of years, plaintiffs firms that have lost a request to enjoin the transaction have begun to pursue more cases, post-closing, seeking monetary damages from the target's board, and their D&O insurer. This is a function of several large dollar post-closing settlements, including the $200m

settlement in the original Kinder Morgan buyout, and the $89m settlement in the KKR/Del Monte buyout. If not disposed of on a motion to dismiss, these post-closing cases can become costly and time-consuming, as defendants cannot settle them for supplemental disclosures and the other alternatives to a monetary settlement are quite limited. We are also seeing some significant appraisal actions being brought in certain transactions, particularly by risk arb funds, activist investors and other hedge fund investors.

Goudiss: Often shareholders of the seller will bring an action seeking to prevent consummation of a proposed transaction, based on alleged breaches of fiduciary duty by the seller's board, including failure to disclose material information about the transaction in the proxy statement prior to the shareholder vote. It is very rare that courts will grant injunctive relief in such cases, as the legal standard is very stringent – plaintiffs must show irreparable harm absent relief, likelihood of success on the merits and a balance of the equities in plaintiffs' favour – and the availability of monetary damages negates the need for the extraordinary remedy of injunctive relief. Also, defendants will often negotiate with plaintiffs to cure any alleged deficiencies in the proxy statement, often as part of a universal settlement of plaintiffs' claims, thus obviating the need for court intervention.

Mordaunt: Unfortunately, actual or threatened litigation against the company being acquired can prevent the deal from closing, as well as risks identified during due diligence. I have seen that occur in a number of instances, especially when the issue has the potential to be far reaching or substantial, such as costly litigation and damage exposure, potential Foreign Corrupt Practices Act violations, compliance issues and forensic suspicions that arose during due diligence. That said, I do not believe it is as common as it appears. If the buyer truly wants the business for strategic and financial purposes, actual or threatened litigation and risk issues may become a part of the negotiation rather than negating a deal in its entirety. I have seen a number of instances in which the actual or threatened litigation or identified risk issues are carved out of the transaction itself. In these instances, the seller agrees to assume the liability associated with the litigation or risks and indemnifies the buyer. I have seen other instances in which a portion of the seller's proceeds are placed in escrow to pay for some or all of the litigation costs or settlement costs of the litigation, but the actions surrounding the litigation are either solely handled by the buyer or are jointly handled. There can be creative ways to address actual or threatened litigation or identified risk issues rather than cancel a proposed transaction.

CD: When reviewing a takeover proposal, what steps can boards and directors take to minimise the risk of facing litigation once the deal is complete?

Goudiss: Directors should engage outside litigation counsel at the very outset of the process to analyse any potential conflicts and litigation risk, and to work with transaction counsel to build steps into the process aimed at mitigating any risks identified. This may include considerations such as the establishment of a special committee of independent directors to review the proposal – particularly if there are conflicted directors or the proposal is from or is being advocated by a majority or controlling shareholder – negotiation of a go-shop provision, reduced termination fees or inclusion of a majority-of-the-minority voting provision. This would also include having litigation counsel work with transaction counsel to appropriately document in the board meeting minutes board decisions relating to evaluation of the proposal and the process followed. Such integrated, interdisciplinary legal teams also provide the added benefit of enabling the board to quickly mobilise its defence efforts once litigation has been initiated.

Mordaunt: As a financial expert who often comes into the transaction once the claims or litigation has commenced, it often appears that the structure of the agreement itself causes litigation. For instance, items may lack definition. "In accordance with Generally Accepted Accounting Principles" may in actuality be a vague definition, particularly when it is 'consistently applied'. If an earnout is to be calculated based on a financial or milestone metric, the specifics necessary to derive the calculation should be considered. Is the buyer permitted to merge the newly acquired company into another and operate it how it wants to, or does it need to keep the business operating consistent with past practices for purposes of the earnout? If there are cost synergies from the merger consolidation, does the seller enjoy the benefit via the earnout? In other words, if the earnout threshold is not met, what measures are in place to make such a determination

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Alan Goudiss, Shearman & Sterling LLP

– do you examine sales by customer, by sales representative, discounts and trade practices, returns and allowances, and so on. The more definition in the agreement, the less likely a dispute will arise. The one thing that boards and directors can do prior to the deal closing to minimise potential litigation is hire competent outside professionals to assist in vetting the transaction. One also needs to understand why the transaction occurred – was the buyer a strategic buyer or a financial buyer? Did the seller want to sell or was it forced to sell due to economic or shareholder factors? From the buyer's perspective, this would consist of legal, due diligence teams, valuation and possibly earnout specialists. From the seller's perspective, it would include legal, valuation and earnout specialists as well. Additionally, if the seller has retained an investment banking firm to help sell the company, they can provide insight in determining if the buyer is a good strategic fit and will maintain the deal document vault. These experts can possibly cut down on the claims that a company may face, or at least position the company as best as possible within the structure of the transaction. Further, the board and directors as well as outside experts can closely monitor the resolution of issues and risks that were identified during due diligence to ensure timely and thorough mitigation of said issues and risks.

Welsh: Carefully evaluate any actual or potential conflicts of interests afflicting the board of directors and its advisers, including whether any board members or their advisers have any connection to any potential bidders. Carefully weigh any potential banker conflicts, including whether the boards' financial advisers have advised, or have any other connections to, any potential buyers and any request by the bankers to provide financing in connection with the transaction. Consider having counsel interview each member of the board and the board's advisers to flush out potential conflicts. In the case of any potential conflicts, consider forming a fully-empowered special committee of independent directors to negotiate and recommend to the board any potential transaction. The process is also critical, especially a thorough, well-managed process that is carefully documented in detailed and accurate board and committee minutes that reflect all steps taken by the board or committee to maximise value and evaluate alternatives.

CD: In responding to claims and the threat of M&A litigation, what are the first steps that a corporate board and its directors should take?

Mordaunt: I would think the board and directors would contact counsel that assisted them in the transaction and also retain litigation counsel, financial consultants, experts and others if necessary. Any claims and threats at the early stage are just that, and may not have any merit.

However, shareholder derivative or dissenting shareholder suits begin shortly after a transaction is announced, well before the deal closes. Most often this is for 'bump up' claims – the shareholders of the seller want the deal price increased – or for proxy disclosure issues related to the board's decision making process, financial projections and fairness opinions. Many of these claims are addressed and handled early on prior to deal close. The company, counsel and perhaps outside financial advisers will review the claims put forth by the opposing side and determine the appropriate steps as necessary. Much depends on the mindset of the company as well – do they want to defend their position or negotiate the claims away?

Welsh: Two things are important here – first, notify your director and officer liability insurance carriers and review the policy carefully and, second, develop your end-game strategy. M&A litigation can move extremely quickly, especially in tender offers and other transactions with a very short window between signing and closing. It is critically important to both take steps to make sure that the often significant costs of litigating and resolving M&A lawsuits are covered under available insurance, and to plot out the strategy that will get you from the beginning of the litigation to closing the deal and to a settlement or decisive victory in the litigation on the timetable that is necessary. This requires cooperation not only on the business side, but also among the parties' legal teams, which should begin planning a litigation response strategy from the beginning. Delay on either of these fronts – insurance and end-game strategy – is your enemy.

Goudiss: Litigation counsel should be brought on board from the outset of the negotiation process

even before any action has been filed. If there is a shareholder demand letter that precedes the filing of a complaint, the board should consult with counsel, take the necessary steps internally to address the matters raised in the demand, and work with counsel to prepare an appropriate response, while being mindful throughout the process that any actions taken could be subject to scrutiny during subsequent litigation and therefore should be carefully tailored to bolster and not undermine the board's ultimate defence strategy. Once an action has been commenced, the board should work with its counsel to formulate its litigation strategy, considering, for example, whether there should be separate counsel for certain directors; whether to pursue an early settlement strategy with plaintiffs to ensure deal certainty; whether the action is covered by D&O insurance, in which case the insurers should be promptly notified; and where multiple actions have been filed, how and where to consolidate the litigation.

CD: What types of outside assistance could a company and/or directors utilise if faced with potential litigation?

Welsh: Some of the most costly M&A lawsuits in recent years have involved conflicted advisers, especially conflicted financial advisers. It is critically important that both legal and financial advisers be selected with considerable care. Potential conflicts of interest between the advisers and any potential bidder, or any interested party at the target, such as management or a significant shareholder, should be vetted very carefully. Another important consideration is how effective and supportive the advisers will be in the inevitable litigation. Will the banking team include someone who has experience testifying and can serve as a credible witness to help defend the deal process in litigation? Will the bankers cooperate with the board in settling the litigation? It may be advisable to seek terms in engagement letters that explicitly require advisers to cooperate in contesting claims, including by participating productively in discovery and preparation of additional SEC disclosures. Those are important considerations.

"Potential conflicts of interest between the advisers and any potential bidder, or any interested party at the target, such as management or a significant shareholder, should be vetted very carefully."

Peter L. Welsh, Ropes & Gray LLP

Mordaunt: Outside assistance will primarily consist of legal counsel and consultants depending on the type of claim being pursued by the opposing side of the litigation. Counsel focused on the deal and litigation will be key. Further, a financial expert will likely be needed regardless of the type of claim – working capital, earnout or breach of representations and warranties. In many instances, their work will form the backbone of the assessment or rebuttal of any damage amount. They also will conduct forensic investigations into the underlying causes for a breach of representations and warranties and will quantify the impact of their findings in accordance with the deal structure, which can be a fairly complex exercise. These experts can serve as a consultant or as an expert witness in mediation, arbitration or trial. Other experts may be needed as well – labour experts, environmental experts, real estate experts and others.

Goudiss: In addition to litigation counsel, a company might consider engaging a public relations firm to assist it in neutralising any negative publicity from the litigation and the public allegations against its board. As previously noted, for deals involving majority or controlling shareholders or conflicted directors, a special committee of independent directors might be convened to evaluate and negotiate the proposed transaction, and in such cases, the special committee should have its own independent financial and legal advisers. In some cases, a board might also consider hiring an independent financial firm to conduct a fairness valuation, where the independence of the company's financial adviser might potentially be called into question.

CD: When faced with M&A litigation, which forum do you believe is best suited for the case – mediation, arbitration or trial?

Goudiss: The chosen route will depend on the nature of the claims asserted and the type of action brought. Typically, it will be the plaintiffs who determine the forum in the first instance, unless there is some provision in the company's by-laws providing otherwise, such as a mandatory arbitration provision. Contractual claims relating to breaches of the merger agreement might be better suited for arbitration, particularly if the parties are concerned about maintaining the confidentiality of the information subject to the dispute. On the other hand, courts tend to be the forum of choice for shareholder class actions, particularly those seeking injunctive relief, as courts have broader power to grant such relief. Irrespective of the forum ultimately chosen, a key action will be to ensure that where multiple actions are filed, they are consolidated before a single adjudicator, so that the company is not engaged in battle on multiple fronts and can better execute its defence. This will also facilitate

global settlement of the claims, should the company decide to pursue this option.

Mordaunt: The forum depends on the type of litigation at issue and the parties' positions – are they fighting or trying to negotiate? Additionally, most transactions contain an arbitration provision. Working capital disputes are often decided in mediation or in arbitration. For more complex issues, mediation is often attempted, and if it fails, it proceeds to arbitration or trial. More often than not, I have seen working capital and earnout disputes handled through arbitration, and breach of representations and warranties and shareholder derivative matters handled through a formal court proceeding possibly resulting in a trial. Arbitration, if not defined, can take many forms – from private arbitration to the American Arbitration Association to other centres that specialise in arbitration. Further, it can consist of a sole arbitrator or a panel, and depending on the nature of the dispute, may be a financial professional such as a certified public accountant rather than an attorney or former judge. How the arbitration is conducted also may determine the best venue – is it going to be limited in nature or is it going to be similar to a trial? There also is a cost associated with the forum – mediation may be the least expensive option, while arbitrations have the potential to become expensive and trials typically are.

CD: How important is D&O liability insurance as a tool to mitigate personal risks to board members related to M&A litigation? What types of coverage are available, and what levels of protection can they obtain?

Mordaunt: D&O insurance is strongly suggested to mitigate the risks board members and directors face in a transaction. Availability, levels of coverage and protection vary by carrier. Overall, a few routine items to consider are, first, the seller's tail or runoff insurance to provide coverage for wrongful acts prior to deal close which have not been brought as claims as of deal close and, second, whether the new entity has sufficient D&O coverage. There is also specific representation and warranty and indemnification insurance that is available. It is often viewed as a bridge between the buyer's desire for broad representations and warranties and a large escrow amount, and the seller's opposite position. The insurance can also extend indemnification from the seller well beyond the time periods or amounts specified in the transaction. For shareholder derivative suits, D&O insurance is a little more complex. Coverage exists for defence costs, and most of the cases settle. But generally two possible challenges remain: first, who pays the plaintiff's law firm's costs and second, if the outcome results in a higher dollar transaction, is the increase in price part of the coverage costs? Those are two specific items

to pay attention to. In fact, as a result of these types of suits and issues, many carriers provide coverage, but have enacted separate M&A deductibles with much higher deductibles than typical D&O coverage.

Welsh: D&O liability insurance is very important. The costs of defending the target and the target's board in M&A litigation are almost always covered under the target's D&O insurance policy. Similarly, where the bidder is sued on a theory of allegedly aiding and abetting the target board's alleged breach of fiduciary duty, the costs of defending those claims will typically be covered under the bidder's D&O policy. Also, the payment of a compulsory attorneys' fee to the plaintiffs' attorneys – as part of a settlement of the litigation, for example – will sometimes be covered under the target board's D&O policy. Monetary settlements may also be covered, depending on the nature of the settlement and the terms of the target's D&O policy. D&O carriers have begun to try to reign in coverage for M&A litigation in recent years, however, so it is important to review the D&O policy at the underwriting stage, before any deal is in the offing, to ensure that coverage is maximised for the risk of M&A litigation.

Goudiss: D&O liability insurance can be a useful tool to mitigate liability risks to board members arising out of M&A transactions. Such policies typically cover liability and defence costs, with exclusions for intentionally wrongful conduct. They have also historically covered attorneys' fees paid to plaintiffs' counsel in connection with the settlement of shareholder class action claims, but increasingly insurers have been resistant to covering such fees and have been demanding some form of contribution from the buyer. There are various levels of D&O protection available, depending on the company's specific risk profile. In the immediate aftermath of the financial crisis there was a spike in the cost of D&O liability insurance, but costs have since stabilised and rates today are slightly more affordable.

CD: In your opinion, are D&Os doing enough to manage the potential risks and liabilities that emerge from M&A related litigation?

Welsh: Much of M&A litigation is frivolous and has nothing to do with what the target's board has done to manage risk. In my experience, although bidders often push the envelope to promote deal certainty and discourage competition, and while some target companies have inevitable risks like a significant shareholder, target boards and their advisers are pretty disciplined in running public company M&A processes. It is critically important, however, to hire the right legal and financial advisers and run a disciplined process in good faith. If that is not done, what might otherwise be frivolous litigation,

can pose real risks to the deal and possibly a risk of personal liability to the board.

Mordaunt: I would say the issue depends on the specific company and D&Os involved. Most large transactions appear to have been well thought out with appropriate D&O insurance in place. Independent outside counsel and financial and due diligence experts are retained during the transaction phase to minimise potential litigation in the future. That said, litigation still likely will happen at some point even in the large transactions, as most large transactions involving public companies often have accompanying shareholder derivative actions. Further, if the deal involves an earnout, the vast majority result in a dispute of some sort. In the smaller transactions, however, this level of scrutiny often does not occur. Due diligence will be performed in only certain areas, not enough focus is given on the definitional terms or measurements in the agreement, all insurance needs are not thought through, and so on. It's a 'get the deal done' mentality rather than looking at what future litigation and related costs could be prevented by utilising a thorough, detailed, comprehensive approach and outside professionals. This is where the disconnect lies. CD