KIRKLAND & ELLIS

KIRKLAND **M&A UPDATE**

January 14, 2013

An Ounce of Prevention — Some Guidance for Target Boards

By studying recent deal-litigation claims and decisions, boards of target companies engaged in a sale process can take proactive steps to reduce the likelihood of an unfavorable litigation outcome.

With litigation now an inevitable feature of the deal landscape, boards evaluating the sale of their company would be well-advised to understand the variety of claims that are being made by plaintiffs in these cases, and in particular those that have gained traction with the courts. While directors taking appropriate steps to address the underlying issues will by no means ensure that litigation will not be brought, the risk of an adverse outcome can be significantly reduced by advance preparation and proactive engagement. With the ever-changing nature of claims and creativity of the plaintiffs' bar, the outline below is not intended to be exhaustive, but rather to offer some practical guidance to target boards as they structure their sale process.

Adviser Conflicts — One of the earliest decisions in a sale process is the selection of a financial adviser. That choice will often be later challenged with questions as to the integrity of the banker's management of the sale process and/or fairness opinion based on the adviser's alleged lack of independence. Plaintiffs frequently will focus on prior work performed by the bankers for the target itself or one or more potential acquirers or the adviser's ownership interests in one or more parties. While there may be circumstances where it is advisable to obtain additional advice or opinions from a separate "conflict-free" adviser, the courts generally have recognized that "conflicts" arising from prior engagements and a bank's routine investing activities are an inevitable feature of today's deal environment. Rather than mandating that boards reflexively disqualify these advisers, who because of industry expertise or familiarity with the parties may be the best choice for the assignment, courts expect that directors, at the outset of the engagement, fully understand the nature and extent of these prior assignments, including the associated fees earned, and ownership interests. This inquiry should be broad in scope, extending to the identity of the individual bankers involved in the prior assignments and the timeframe in which they were completed. Advisory fees should be constructed in a fashion that best aligns the interests of the adviser with the optimal outcome for target shareholders in the particular circumstance, noting that there is no one fee model appropriate for all situations. Finally, targets should consider appropriate public disclosure in the proxy statement or tender offer documents of the board's inquiry and understanding of potential conflicts, as well as the steps taken to address any of these issues.

Projections — The development, use and disclosure of projections of future performance by the target are another area that would benefit from proactive engagement by the target board. While many companies do not regularly maintain and update detailed financial projections extending well into the future, the management team of the target will be expected to create such a set of projections early in a sale process, and refinements and changes to those projections have proven fertile ground for hindsight criticism. While a board is not necessarily expected to actively participate in the generation of these projections, directors should ensure that they fully understand the underlying assumptions and drivers as well as the purpose for which a particular set of projections is being created. A not uncommon fact pattern features an optimistic set of projections sent to a potential buyer early in the process, followed by the board being later offered a lower set of projections as it engages, with the assistance of its financial adviser, in its valuation exercise and consideration of the fairness of the final price offered. While the cynical view often painted by plaintiffs is of treacherous executives, directors and advisers creating a last-minute pessimistic set of projections designed to justify an unfairly low price in a deal motivated by a myriad of self-interested actors, in an overwhelming majority of cases the reality is much less sordid. The optimistic set of projections sent to a buyer may be part of a "sales job", designed to generate the highest possible interest and price from buyers. Buyers inevitably will apply their own discounts and assumptions to these projections, recognizing their purpose and provenance. Equally, an alternative and more sober set of projections, often created later in the sale process, may be more reflective of management's and the board's best estimates of realistic expectations, and therefore an appropriate basis for a board's valuation, and

Attorney Advertising

evaluation, exercise at the end of the process. Rather than an unquestioning acceptance of a final lower set of projections, courts expect that target directors understand the genesis, development and drivers of the various sets of projections that may be floating around, as well as the impact of these various cases on the valuation exercise. Finally, where appropriate, targets should consider measured disclosure of the various cases in public documents, preemptively offering the target shareholders insight into the board's oversight and reasoning in the projections process.

NDAs and Standstills — Perhaps no issue has garnered more recent attention in Delaware legal circles than confidentiality agreements and implicit or explicit "standstill" obligations which, in general, prohibit potential buyers from later making an unsolicited offer for the target after obtaining access to nonpublic information. While the minutiae of these standstills have long been viewed as the esoteric province of legal professionals, recent cases have shown that courts expect that directors at least understand the interaction between these provisions and their conduct of a value-maximizing sale process. In some recent cases, the courts have focused on the impact of so-called "don't ask, don't waive" standstill provisions which not only prohibit the making of an unsolicited offer, but also restrict the potential buyer from making its interest known to the target board absent an explicit invitation. Courts have questioned whether boards are violating their duty to make informed decisions if the standstill provision may deprive them of knowledge of potential bidding interest. The cumulative take-away from these recent decisions is that targets and their directors need to appreciate that standstills, and particularly "don't ask, don't waive" provisions, are powerful tools that need to be used thoughtfully and carefully in pursuit of the value-maximizing outcome. While there are circumstances where these provisions are warranted — for example, a measured pre-signing auction process where the finality of an airtight standstill motivates bidders to offer their "best-and-final" price — boards should understand their deployment and the underlying rationale and evaluate their continued usefulness and propriety throughout the sale process. In addition, where appropriate, targets should consider public disclosure to shareholders of the existence and extent of these standstill provisions so their vote or tender decision is made with the knowledge of the bidding landscape.

Motivations — Delaware law, as well as the law of many other states, continues to recognize the primacy of price-maximization for shareholders as the board's sole objective in a cash sale transaction. As a result, alleging all manner of competing motivations on the part of deal participants has become a favorite pastime of plaintiffs' lawyers. These include social or business relationships among individuals, economic benefits to executives from preexisting severance or change-of-control arrangements, and liquidity pressures affecting controlling shareholders. Except in egregious circumstances where the court finds that resulting incentives overwhelmed the basic goal of achieving the best price, courts readily accept the proposition that executives and directors are human beings, with personal and economic impulses — financial investors properly desire liquidity on their investment and executives may benefit from contractual protections triggered by a cash-out transaction. What is expected from directors is an attempt early in the sale process to survey the variety of potential "conflicts" that may exist and the enactment of appropriate safeguards given the circumstances. A corollary benefit to a particular person does not generally require a reflexive exclusion of that person from the sale process but rather awareness of that interest coupled with suitable oversight to manage the resulting risk. Once again, appropriate disclosure to shareholders of the board's awareness of these issues, as well as the steps taken to address them, rounds out a thoughtful approach.

* * * *

While deal litigation is in most cases a nuisance, boards of target companies can draw lessons from recent claims and decisions and take proactive steps to reduce the likelihood of an unfavorable outcome, whether in the form of injunctive relief, costly settlement or post-closing damages claim. Happily, those steps generally don't require wholesale substantive changes to the way a target conducts a sale process or selects its advisers. Rather, a spoonful of awareness and disclosure can go a long way to avoiding a litigation-mandated cure.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

Sarkis Jebejian
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/sjebejian
+1 212-446-5944

Daniel E. Wolf
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dwolf
+1 212-446-4884

This communication is distributed with the understanding that the author, publisher and distributor of this communication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this communication may constitute Attorney Advertising.

© 2013 KIRKLAND & ELLIS LLP. All rights reserved.

www.kirkland.com