Strafford

*Presenting a live 90-minute webinar with interactive Q&A*

# Responding to an Unsolicited Acquisition Offer: Board Fiduciary Duties and Strategic Considerations

Advance Preparation, Conflicts of Interest, Application of the Business Judgement Rule

WEDNESDAY, JANUARY 6, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Francis J. (Frank) Aquila, Partner, **Sullivan & Cromwell LLP**, New York

Christopher D. Barnstable-Brown, Partner, **Wilmer Cutler Pickering Hale and Dorr LLP**, New York

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

# *Tips for Optimal Quality*

FOR LIVE EVENT ONLY

*Sound Quality*

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

*Viewing Quality*

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

## *Continuing Education Credits*

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

## *Program Materials*

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

WILMERHALE®

WILMER CUTLER PICKERING HALE AND DORR LLP ®

# Responding to an Unsolicited Acquisition Offer

Frank Aquila – Partner, Sullivan & Cromwell LLP
Chris Barnstable-Brown – Partner, WilmerHale LLP

# *Outline*

- Current Outlook for Unsolicited Proposals
- Responses to an Unsolicited Proposal
- Key Players/Assembling the team
- Board Duties and Standards of Judicial Review
- Identifying Potential Conflicts
- Takeover Defenses
- Conclusion

# *Current Outlook - Overview*

- Unsolicited activity is likely to continue as strategic buyers continue to seek opportunities and potential targets fail to reset pricing expectations
- Historically, unsolicited activity has increased in light of market dislocations and depressed sectors, including as a result of the COVID-19 pandemic
- Activist shareholders (and proxy advisory firms) will continue to pressure companies to take actions to enhance shareholder value
- Shareholder pressure translates into directors being less likely to "just say no", even when well within their fiduciary duties to do so
  - In the face of a public bid, shares tend to trade quickly into the hands of arbitrageurs and hedge funds
- Sales of distressed companies and divestiture of noncore businesses will likely increase

# *Responses to an Unsolicited Proposal*

- "Unsolicited" vs. "Unwelcome": Most public bids begin with informal attempts to discuss a deal with management and/or directors, and many boards would welcome an interested bidder – at the right price
- However, receipt of a proposal or evaluating/discussing any such proposal with the board or the bidder does not require the Company to commence any sale process
- There is no mandated time frame for responding to an unsolicited proposal
  - Bidder may seek to impose such a time frame, but Bidder should understand that any reaction to such a proposal would first require board discussion

# *Responses to an Unsolicited Proposal*

- Receipt of an offer does not trigger an affirmative disclosure obligation
  - As long as proposal is made confidentially and does not "leak" out, the Company can treat it confidentially
  - Company should limit information to those who need to know
- But Company should be prepared to issue a public statement if the bidder decides to make public or if market rumors arise and Company is called by its stock exchange inquiring if it is aware of reasons for rumors or price movement
  - If an aggressive or fully hostile bid, Company should be prepared with a "break-the-glass" communications response plan
- Company also needs to consider whether "blackout" should be imposed on Company or insider market transactions

# *Responses to an Unsolicited Proposal*

- Any bona fide offer should be promptly communicated to the Board as a whole
  - Board is the appropriate decision making body
  - If an officer or board member is individually approached, response should be to acknowledge offer, not comment on merits or advisability but to note that it will be shared with the Board
    - Similarly, individual recipient of proposal should not be dismissive or say "the Company is not for sale"
- It is important that the Board and management "speak with one voice" so any "one-off" discussions should be avoided and communications should be scripted
  - If bid is or may become public, need for coordinated and rapid responses on all levels
- Board should inform itself and apply constructive skepticism – asking hard questions and challenging and testing management's assumptions to ensure that all reasonable aspects of any potential deal have been considered

# *Responses to an Unsolicited Proposal*

- A more aggressive communication, such as a "bear hug letter," indicates that a bidder has readied a plan to force negotiations, including through a public offer. Board responses must be thoughtful, planned and choreographed. Alternative responses may include:
- Communication and negotiation with Bidder
  - Note that Target will require a confidentiality and standstill agreement
- Third Party Alternatives
  - White Knight
  - Conduct a market check or auction

# *Responses to an Unsolicited Proposal*

- Proactive Restructuring/Strategic Steps to Create Near-Term Value
  - Leveraged share repurchase/extraordinary dividend/recapitalization
  - Equity placement (White Squire/ESOP)
  - Restructuring/Acquisitions/Divestitures/Spin-off
  - Significant commercial or business arrangements, such as collaborations or strategic partnerships/alliances
  - Board refresh
- Pursue “stand alone” independence
  - Difficult to maintain “just say no” indefinitely in many circumstances
  - Requires united Board, high management credibility
  - Outreach to investors is critical
  - Either weak offer or strong defenses

# *Key players: Assembling the Team*

- Size and scope of team will depend on nature of proposal and the Board's strategy, but it is critical that an appropriate team under the circumstances be assembled and quickly in place
  - Best time to have advisors lined up is on a "clear day"; there should be no debate about who the initial calls go to
- Typical team in response to an unsolicited proposal consists of a few key executive officers, legal counsel, and one or more financial advisors, as well as a proxy solicitor and a public relations firm
  - In particular, a proxy solicitor and public relations firm will be essential in crafting and communicating the Company's message if the unsolicited bid becomes public
  - Screening for conflicts is essential
- Board must be able to convene special meetings quickly with the team when material developments arise

# *Board of Director Duties*

- If Board satisfies its fundamental duties of care and loyalty (including good faith) regarding an unsolicited proposal, then courts will review that decision under the deferential business judgment rule, presuming that the Board acted properly and in the best interests of the Company and its shareholders
- However, if the Board decides to adopt a defensive mechanism in response to the unsolicited bid, approve a transaction involving the sale of control of the Company, or accept a merger agreement provision that limits the Company's ability to consider or accept competing bids, the Board will face heightened judicial scrutiny
- Courts continue to emphasize the importance of minutes and other contemporaneous written records of the board's consideration of an M&A transaction. These records will be given significant evidentiary weight in a litigation challenging the actions of the board, and due care should be taken regarding the written record

# *Board of Director Duties*

- Duty of Care: To act on informed, deliberative basis with same level of care and diligence as a reasonable person would in similar circumstances based on all material information reasonably available
  - Board must be informed and active – can rely on experts including bankers and counsel, but can also rely on own industry and market knowledge and knowledge of the Company and its prospects
- Duty of Loyalty: To act (including deciding not to act) on a disinterested and independent basis, in good faith, with an honest belief that the action is in the best interests of the company and its stockholders
  - Should consider whether bidder or terms of the offer creates a potential conflict for any director

# *Shareholder Duties and Considerations*

- Unlike directors, shareholders are free to make determinations unilaterally, without duties or obligations to other shareholders, in their *capacities as shareholders*
  - If shareholder has nominee/affiliate on the Board, it is important for that director to clearly delineate whether activity or speech is being made in her/his capacity as a shareholder or as a director
  - If possible, it may be advisable for such shareholder to have a non-director officer or member speak in its capacity as a shareholder
- It is important for shareholders to consider reporting obligations if they have more than 5% of outstanding shares, or acting together with other shareholders would have 5% or more

# *Standards of Judicial Review – Business Judgment Rule*

- In general, Board determinations should be accorded significant deference and, if challenged, would be subject to the "Business Judgment Rule"
  - Courts generally will presume that directors acted on an informed basis and in the good-faith belief that the action was taken with the best interests of the company
- Board should be able to consider the perspective of shareholders with nominees on the Board
  - This does not eliminate duties or obligations on directors, but can be considered (for example, if shareholders indicated opposition and held sufficient voting power to block a transaction)
- Courts will, however, apply heightened judicial scrutiny in certain circumstances

# *Standards of Judicial Review – Revlon Duties*

- Enhanced obligations, known as "*Revlon* duties," arise if and when the Board determines to pursue a transaction that results in a change in corporate control
  - Directors "have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders"
  - A court will examine (i) the reasonableness of "the decision-making process employed by the directors, including the information on which the directors based their decision," and (ii) "the reasonableness of the directors' action in light of the circumstances then existing"
  - For example, if the Board rejects a Bidder's offer and instead agrees to a friendly deal with a "white knight," the Board's *Revlon* duties will limit its ability to protect that deal through lock-ups or break-up fees, while a "fiduciary out" provision in a negotiated agreement which gives the Board flexibility to negotiate and accept superior offers may help the Board meet its Revlon duty in the absence of a pre-signing auction or market check

# *Standards of Judicial Review – Revlon Duties*

- There is no single blueprint that a board must follow to fulfill its *Revlon* duties
  - Consulting with financial and legal advisors on the process to follow is important
- The question for a court to answer is whether the directors made a reasonable decision, not a perfect decision
- Steps may include:
  - The board has engaged in a pre- or post-signing market check;
  - The market is aware that the company is up for sale;
  - The board has thoroughly considered strategic alternatives;
  - The board received a reliable opinion from its investment bankers;
  - The board has extensive knowledge about the company and its worth;
  - No third party inquired about making a competing bid; and/or
  - The transaction agreement lacks onerous deal-protection mechanisms.

# *Standards of Review – Defensive Measures*

- Enhanced scrutiny is applied when a board implements defensive measures in response to an unwanted advance or perceived threat.
- In these circumstances, courts will scrutinize: (i) the board's decision-making process; (ii) the information on which the decision was based; and (iii) the reasonableness of the board's actions.
  - The Board must show that it had reasonable grounds to believe that a threat to the company existed and the defensive actions taken were reasonable in relation to the perceived threat (*Unocal*)
  - The Board should avoid adopting defensive measure(s) that would preclude all other offers or coerce shareholders to approve a management-sponsored bid
  - To satisfy the *Unocal* test, the Board should ensure that there has been a reasonable and good-faith investigation before implementing any defensive measures

# *Standards of Review – Entire Fairness*

- "Entire fairness" review applies where a plaintiff can show that directors did not act on an informed basis or in good faith, or that a conflict exists (such that the business judgment rule presumption is rebutted)
  - Typically arises when there is a controlling stockholder transaction or if a significant number of the directors involved with approving the transaction were deemed to have been conflicted
- In this case, the Board will bear the burden of proving that the transaction was entirely fair, both as to (i) process or "fair dealing" (how the transaction was initiated, structured and negotiated) and (ii) "fair price" (a price that a reasonable seller would consider within a fair-value range)
  - The entire fairness standard imposes a heavy burden, and whether or not it applies often dictates the outcome
  - The Board should require the directors to disclose potential conflicts before the Board makes any decision

# *Standards of Review – Entire Fairness*

- Burden of proving entire fairness will shift back to the plaintiff where a transaction with affiliates (directors, management or a significant shareholder) that involves conflicts is approved by a special committee of independent and disinterested directors with appropriate powers and independent advisors, or a majority of disinterested shareholders
- In certain transactions involving a controlling stockholder, directors may receive the benefit of the business judgment rule presumption if both a special committee is used and the transaction is approved by a majority of the disinterested shareholders
  - Recent caselaw makes clear that the special committee must be in place *ab initio* before "economic negotiations" take place, i.e., before price/valuation discussions occur

# *Identifying Potential Conflicts*

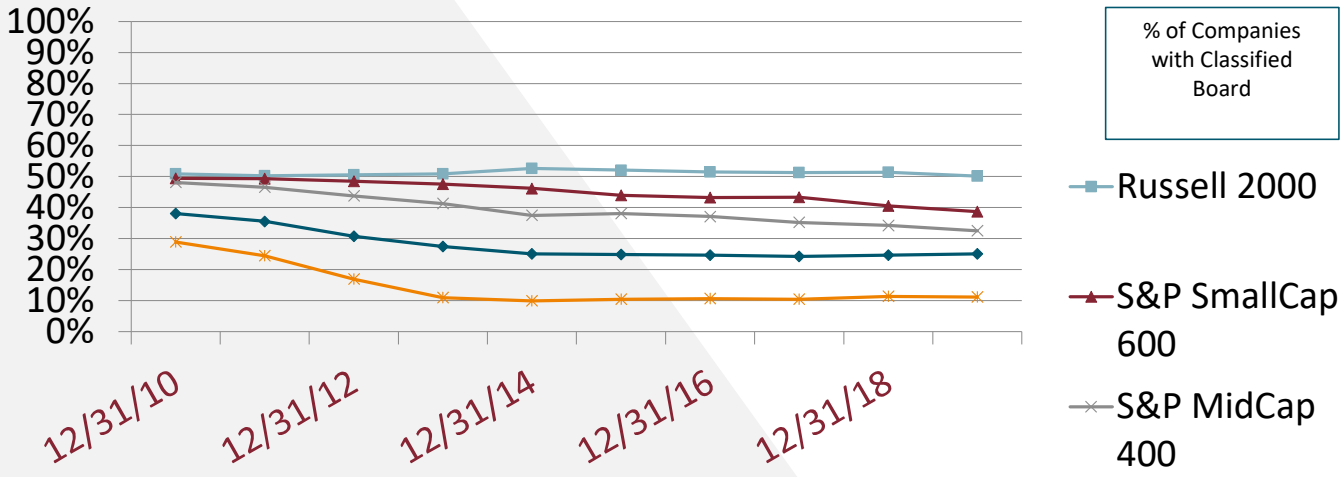
- Director and Management Conflicts:
  - an interest in continued employment or a position
  - a severance payment upon a change in control
  - a reputational interest in leading a larger entity
  - interest in a management/sponsor buyout of a piece of the company after the deal has closed
- Financial Advisor Conflicts: Board must understand the interests of its advisors, including prior or current relationships between its financial advisor and potential bidders. Special care is needed when a financial advisor:
  - is involved on both sides of the transaction (whether as an advisor or a provider of financing)
  - holds equity in either or both of the participating companies
  - is incentivized to pursue a particular deal at the expense of other deals

# *Takeover Defenses: Current Outlook*

- Pressure to dismantle takeover defenses has made U.S. companies more vulnerable
  - Institutional investors and proxy advisory firms have strongly supported measures aimed at eliminating staggered boards and rights plans in recent years, and they have become more vocal
  - Majority voting in elections of directors (as compared to elections by plurality) gives shareholders a tool to exert greater influence, and is being adopted with increasing frequency
  - Similar trends are being experienced by non-U.S. companies

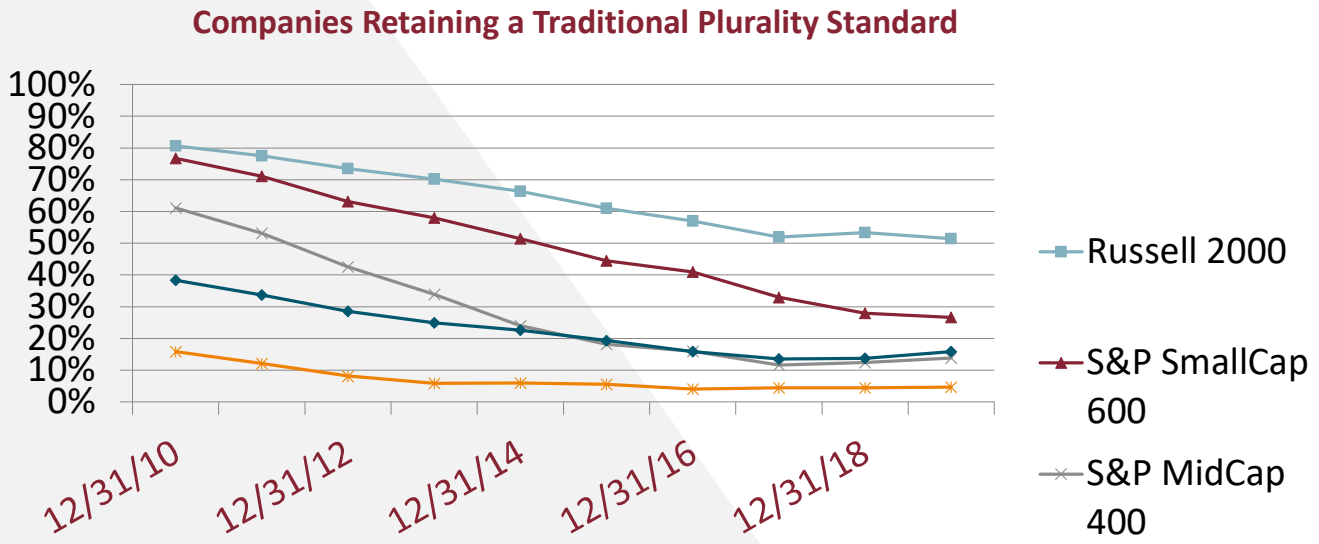
# *Trend Away from Classified Board is Continuing*

- Among large cap companies, classified boards are uncommon; majority of S&P 500 has been declassified since 2006 (source: Sharkrepellent data)
- Since 2010, a growing number of mid-caps have declassified, while small-caps have shown less change



# *Clear Trend Away from Traditional Plurality Standard*

- Until 2005, plurality voting standard was nearly universal
- Today, it has almost disappeared at large-caps and has notably declined at mid- and small-caps (source: Sharkrepellent data)



# *Takeover Defenses - Overview*

- Board should conduct a review of the Company's organizational documents to determine what defenses are in place and what additional defenses can be implemented
  - Defensive measures do not (and should not be used to) defeat an unsolicited proposal supported by shareholders, but the Board can (and should) use such defenses to exert leverage in negotiations and control any process and consider alternatives
  - The most valuable thing defensive measures can provide the Board with is time – but the Board should not necessarily expect such measures to provide more than that

# *Takeover Defenses – Shareholder Rights Plans*

- Shareholder rights plans (or poison pills), which give shareholders other than the bidder the right to purchase newly issued shares at a discount when the bidder amasses a certain stake without the board's approval, remain among the most effective – and heavily criticized – takeover defenses
  - As a result, many companies have eliminated or not renewed their poison pill or watered it down with "shareholder friendly" provisions, such as oversight by independent directors or sunset clauses requiring redemption if not ratified within a certain period
  - On the other hand, many companies have pills "on the shelf," ready to be put in place quickly (and without a shareholder vote)
  - A pill nonetheless can only delay a motivated bidder until the next shareholder meeting, as a bidder could launch a proxy contest to effect a change of control of the board (but not if the board is classified)

# *Takeover Defenses – Other Alternatives*

- Other defenses, if available, may also improve the Board's negotiating position. For example:
  - A staggered or classified board
  - Prohibitions on shareholder action by written consent would limit the Bidder's ability to remove and replace directors without a shareholder meeting
  - Prohibitions on the shareholders' ability to call a special meeting would limit the Board's "window of vulnerability" regarding proxy contests to once per year
  - Prohibitions on the ability to put forward shareholder proposals or nominate directors without advance notice to the Board would limit the Bidder's opportunity to surprise the Board with last minute proposal

# *Takeover Defenses – Other Alternatives*

- Restrictions on the removal of directors without cause would prevent the Bidder from removing directors for any reason other than fraud, criminal acts, or other wrongdoing
- A cap on board size could thwart attempts to "pack" the Board by increasing the Board's size
- If the Board has the ability to amend by-laws, it has flexibility to adopt and tweak defensive measures without having to wait for shareholder approval. Conversely, a supermajority shareholder vote requirement to amend certain by-law provisions could prevent the Bidder from changing corporate documents to eliminate takeover defenses

# *Takeover Defenses – Other Alternatives*

- State statutes may provide another layer of protection against an unwanted takeover. For example, the Section 203 of Delaware General Corporation Law, restricts mergers with a party that owns or has owned 15% or more of the outstanding voting stock of the company within three years of the proposed merger, unless the Company's organizational documents provide that the Company has opted out of such "Interested Stockholder" protections

— Many of these, including a staggered or classified board, would require a shareholder vote to approve a change to the Company's charter, so unless the Company already has such measures in place they will not be available at the time of an unsolicited proposal

# *Conclusion: Shareholders Ultimately Drive the Deal*

- Shareholders today have little tolerance for frustrating actions or delay
- Shares trade quickly into the hands of arbitrageurs and hedge funds
- Arbitrageurs, hedge funds and shareholder advisory services are likely to support a bidder to get a deal done
- Whatever paths the Board chooses in light of an unsolicited proposal, it should be prepared to provide a compelling vision and narrative to shareholders
- The success of a “remain independent” response to an unsolicited proposal is highly dependent on the Board’s and management’s ability to develop credible strategic alternatives to the bid, and failure to consider such alternatives weakens a Board’s ability to resist an unsolicited proposal

# *Conclusion: Shareholders Ultimately Drive the Deal*

- When all is said and done, the independent directors will listen to the shareholders rather than management (and, offer price drives the shareholders!)
  - Less deferential to CEO on change of control matters, especially where shareholders are actively monitoring
  - Reputational risk – litigation and proxy contest – is ever present for resistant Boards once an offer is public

# *Contact Information*

Francis J. (Frank) Aquila
Sullivan & Cromwell
aquilaf@sullcrom.com

Christopher D. Barnstable-Brown
Wilmer Cutler Pickering Hale and Dorr
chris.barnstable-brown@wilmerhale.com