

MERGERS & ACQUISITIONS: A MINEFIELD FOR DIRECTORS

When a company becomes involved in an actual or proposed merger or acquisition (“M&A”), its directors are thrust into a highly volatile and dangerous claims environment. Particularly with respect to directors of the acquired or target company, any decision to approve or reject the transaction will likely disappoint some constituents who can—and frequently do—sue the directors for alleged wrongdoing in connection with the transaction.

A combination of factors explains why especially directors of the target company are so vulnerable in this context. By definition, the transaction involves the very existence of the company and is one of the most important decisions a Board must make. Huge amounts of money are at stake, and thousands of employees, vendors, customers and other constituents will be affected. These transactions typically move quickly, so directors must make monumental decisions in a very short time period without as much information or deliberation as ideally preferred. No director is entirely disinterested in the outcome, since the target’s directors will probably lose their lucrative Board seats but will realize an attractive gain on the company shares they own if their company is acquired. Finally, directors must deal with these challenges while being critically and closely watched by investors, the press and—most importantly—plaintiff lawyers.

These issues are particularly relevant today since M&A transactions are now at near record levels. Several factors are causing the renewed popularity of acquisitions. Institutional investors are being more proactive in pushing companies to sell unprofitable or underperforming businesses. In addition, companies which want to expand frequently conclude that buying a competitor is faster and more economical than internal growth, particularly when interest rates are low and stock prices are not inflated. Also, hedge funds and private equity funds with an enormous appetite for high-yield investments are more frequently combining to bid on undervalued companies. Whatever the reason, while M&A activity is high, director susceptibility to claims also is high.

I. D&O Claims History

In the mid- to late 1980s, corporate raiders, with the support of numerous court decisions defining director duties in a change-in-control situation, acquired virtually any company they wanted through hostile takeovers. By offering to pay a substantial premium to shareholders, these raiders leveraged to their advantage the target directors’ inherent vulnerabilities in this context. Directors who rejected the takeover bids were routinely sued and frequently incurred large losses.

During that era, three fundamental principles emerged from court decisions defining the standards of directors in a takeover context. Those fundamental principles continue today to define director responsibilities in a change-in-control situation.

1. The board of directors must make a thorough, well-documented investigation before acting;
2. Any defensive measure adopted by the board must be reasonable in relation to the reasonably perceived threat imposed by the takeover bid; and
3. If the board abandons its long-term strategy in response to a hostile offer by agreeing to sell the company or by seeking an alternative transaction involving the break-up of the company, the board must not unreasonably interfere with an open, unrestrained bidding process.

Beginning in the early 1990s, the judicial climate for directors in a takeover situation began to improve. Ultimately, the Delaware Supreme Court recognized that courts should give directors a great deal of latitude in reacting to a takeover proposal. According to the Court, if remaining independent is consistent with the company's long-term strategy, directors can "just say no" to even very rich takeover bids without breaching their fiduciary duties. Most other states followed this Delaware precedent, so today directors generally have wide discretion in accepting or rejecting an acquisition proposal.

This shift in judicial attitude regarding director behavior in change-in-control transactions caused a major change in the M&A world. Hostile takeovers pursuant to which raiders acquired unwilling companies by offering large premiums over market price virtually disappeared since the target's board of directors could implement effective defenses without serious risk of personal liability. Instead, "friendly" acquisitions driven by strategic considerations became the norm. In the rare event a hostile takeover was attempted, the raider would typically conduct a proxy contest to acquire a majority of the target's board seats, thus allowing the raider to accomplish a "friendly" acquisition without the interference of an objecting board.

Unfortunately, this more deferential climate has not insulated directors from all litigation involving change-in-control situations. Even today, D&O claims susceptibility and frequency materially increase if a company is involved in an actual or proposed M&A transaction. Although directors and, to a lesser extent, officers of the target or acquired company are the most likely defendants in such litigation, directors and officers of the acquiring company may also be sued for perceived wrongdoing under certain circumstances. Examples of the type of D&O claims which may be filed in an M&A context include:

A. Disclosure

The greatest D&O liability exposure today relating to M&A transactions relates to alleged misrepresentations to investors regarding the negotiation, terms or effects of an M&A transaction. Class action securities lawsuits are frequently filed against the target D&Os alleging

that the defendants did not accurately, completely and timely disclose the existence of the M&A negotiations or other material information about the transaction. Courts have refused to articulate a bright-line rule for determining when M&A negotiations must be publicly disclosed. D&Os are thus placed in a dilemma, not wanting to disclose the existence and terms of the negotiations either prematurely or delinquent. If disclosure is too early and the transaction does not occur as disclosed, shareholders who purchased stock after the disclosure will allege they were injured because the defendants artificially inflated the stock price by the premature disclosure. If disclosure is too late, shareholders who sold their stock prior to the disclosure will allege they were injured since they sold their stock prior to the large price increase following the merger announcement.

Securities class action lawsuits can also be brought against the D&Os of the acquiring company, alleging the defendants failed to fully and timely disclose the M&A negotiations or misrepresented the future prospects or likely effect of the acquisition on the acquiring company. Like other types of securities class actions against D&Os, these suits can involve huge potential damages and result in increasingly large settlements.

B. Resist Hostile Takeover

In the unusual situation where a company is the target of a hostile takeover bid, directors of the target company who resist the hostile takeover attempt will likely be sued. Disgruntled shareholders typically allege that the directors breached their fiduciary duty by resisting the takeover proposal, thereby denying the shareholders the opportunity to sell their shares at the much higher offer price. The amount of recoverable damages in such a claim can be enormous, and therefore the settlement value of such a claim can be quite large even if the liability exposure is relatively small in light of the broad discretion courts now give directors in such a situation.

C. Approve Friendly Takeover

The directors of a target company who approve an acquisition of their company also are frequently sued by shareholders, who allege that the directors failed to make an informed decision regarding the adequacy of the purchase price or failed to “shop” the company. These cases are typically less severe than the hostile takeover cases since the potential recoverable damages are usually much less. Shareholders in this type of litigation frequently seek a bump up in the purchase price, as opposed to the entire acquisition premium which is at issue in D&O lawsuits involving hostile takeovers. These types of cases usually either settle for a relatively modest amount or eventually are dismissed for lack of merit.

D. Pre-Acquisition Mismanagement

After a company is acquired, the new owners and their appointed managers may determine that the directors and officers of the acquired company mismanaged the company prior to the acquisition and therefore may sue the prior D&Os for the injury caused to the company. These claims are not common since the acquiring company typically conducts a thorough due diligence investigation before agreeing to purchase the company. However, this

type of claim is brought occasionally and is particularly problematic for the defendant D&Os since they no longer control the company or its indemnification or insurance programs when the claim is made.

E. Mismanagement of Acquisition

D&Os of the acquiring company can also incur liability exposure in connection with the management of the acquired company after the acquisition or the disclosure of the actual results of the transaction. This exposure has proven particularly problematic when the acquisition is part of a diversification program of the acquiring company since D&Os of the acquiring company frequently have little experience with respect to management of a company in a completely new industry or market.

II. D&O Financial Protection

Unique and difficult issues arise when structuring a comprehensive D&O financial protection program in the M&A context. Like any D&O financial protection program, both indemnification and insurance issues should be addressed. How those issues are resolved depends in part on the structure of the acquisition transaction. If the acquisition is accomplished through the purchase of the target company's securities, the target company will remain in existence as a subsidiary of the acquiring company. If the acquisition is accomplished through a merger, the target company no longer will exist but will become part of the acquiring company. The source of the target D&Os' financial protection after the acquisition will obviously vary depending on which type of acquisition structure is utilized.

A. Indemnification

Indemnification issues in a change-in-control situation are challenging because a person's right to indemnification is determined when the D&Os incur the loss, not when the alleged wrongdoing occurs or when a claim is made against the D&Os. Losses arising out of pre-acquisition wrongdoing can be incurred years after the acquisition. Because D&Os of the target will no longer control the target following the acquisition, they need to lock in their future indemnification rights before the acquisition is finalized. That can be accomplished in several ways.

First, if the acquisition will result in the target remaining in existence as a subsidiary of the acquiring company, the target should include in its mandatory by-law indemnification provision prior to the acquisition a clause which recognizes that the by-law indemnification rights and obligations are contractual in nature and which prohibits the company from retroactively amending or repealing the D&Os' indemnification rights with respect to any alleged wrongdoing taking place before such amendment or repeal. With such a by-law clause, there would be no need for separate indemnification agreements with each director or officer.

Second, the target D&Os should include in the acquisition agreement a provision requiring the acquiring company (as well as the target if the target survives as a subsidiary) to unconditionally indemnify the former D&Os of the target to the fullest extent permitted by law.

That contractual provision should contain all of the protective concepts included in a broad by-law indemnification provision, such as:

- The Company is obligated to advance defenses costs until a determination is made whether the director or officer is entitled to indemnification.
- The mandatory indemnification should apply to directors and officers serving at the request of the Company as directors or officers of other entities or as directors or officers of the Company's subsidiaries.
- If a dispute arises between the Company and a director or officer regarding indemnification, the Company has the burden to prove the director or officer is not entitled to indemnification and must pay the director's or officer's legal fees and expenses incurred in enforcing his or her indemnification right if he or she is successful in whole or in part in the dispute with the Company.
- In any legal proceeding relating to the Company's obligation to indemnify, the court must address the issue of indemnification de novo, and there is no presumption arising from the Company's refusal to indemnify.

B. Insurance

Structuring an appropriate D&O insurance program for an M&A transaction is fraught with difficult challenges because of both the number of issues that should be addressed and the inherent conflict between the interests of the target's former D&Os and the surviving company. The following discussion summarizes many of those issues with respect to coverage for wrongdoing before and after the M&A transaction.

Subsequent Wrongful Acts. The acquiring company will obviously need to include the target company in its ongoing D&O insurance program for Wrongful Acts committed after the acquisition. If the acquisition is structured as a merger pursuant to which the target company disappears, there should be no issues. If the target company becomes a subsidiary of the acquiring company, the principle D&O insurance issue is the extent to which the acquiring company's D&O insurer is entitled to receive a notice of, and to underwrite, the acquisition mid-term.

Most D&O policies provide automatic coverage to newly acquired subsidiaries unless the acquired subsidiary exceeds a defined reporting threshold. That threshold is usually based on the value of the target's assets and can range from 10% to 25% of the Parent Company's assets. If the reporting threshold is exceeded, policies vary as to whether the insurer is entitled to charge an additional premium only or to also impose additional terms and conditions to the policy as a condition to future coverage for the acquired company's D&Os. Also, some policies afford automatic coverage for some limited time period (e.g., 60 days) even if the threshold is exceeded. In any event, coverage for the newly acquired subsidiary typically applies only with respect to wrongful acts taking place after the date of the acquisition.

Because M&A transactions often arise with little advance warning, companies should anticipate these issues when purchasing their D&O insurance program even if there is no expectation at that time the company will be acquiring another company during the Policy Period.

Prior Wrongful Acts. The most difficult M&A insurance issues arise with respect to coverage for Claims made after the acquisition for wrongdoing by the D&Os of the target company committed prior to the acquisition. Because the D&Os of the target company may be replaced or removed following the acquisition, they should purchase prior to the acquisition a pre-paid, non-cancelable extended run-off insurance policy which cannot be amended or affected in any way by the acquiring company or subsequent management. In light of applicable statute of limitations in various jurisdictions, the term for this run-off policy often is four to six years. To assure the availability of this coverage, some D&O policies provide that in the event the Company is acquired, the insurer is obligated to issue a quotation for an extended run-off policy.

From the perspective of the target company's directors and officers, this type of run-off policy is much better than a provision in the acquisition agreement which requires the acquiring company to maintain D&O insurance for the former directors and officers of the target company. If the acquiring company intentionally or inadvertently breaches that provision or is unable to maintain such coverage (due to its financial condition or market conditions), the former D&Os of the target company can be left uninsured through no fault of their own. That risk is eliminated if a pre-paid, non-cancelable long-term run-off policy is purchased by the target company prior to the acquisition while those former D&Os still control the target company.

When structuring a D&O run-off policy, a fundamental conflict frequently arises regarding the primary purpose of that coverage. The target company's directors and officers, many of whom may not remain with the company after the acquisition, will want to maximize their personal protection under the policy and will have little if any concern for protecting the target company or acquiring company for claims made after the acquisition. Thus, those directors and officers are best served by purchasing a broad-form Side-A policy, which covers only non-indemnified loss incurred by the directors and officers. Such a policy, which affords far broader coverage than available under a standard D&O policy containing Side B and/or Side C coverages also, would not insure either the target or acquiring companies to the extent they indemnify the former D&Os of the target company or are directly sued in a securities claim. In addition, the limits under such a Side-A policy would not be diluted by company losses, and the policy would not be frozen in the event the company later filed bankruptcy (unlike a policy with Side C and perhaps Side B coverage).

From the Company's perspective, though, a Side-A policy leaves the company uninsured for potentially large indemnification and securities losses. Instead, the acquiring company would prefer the run-off policy contain Side B and perhaps Side C coverages for wrongful acts taking place prior to the acquisition. If the target company's directors and officers ignore those concerns and purchase a Side-A run-off policy, the acquiring company could potentially criticize that decision and pursue remedies either under the acquisition agreement or as successor to

the target company. For that reason, representatives of the target and acquiring companies should discuss and, if possible, agree upon an acceptable structure for the run-off D&O insurance program prior to the closing.

An increasingly popular compromise to the legitimate but competing interests of the directors and officers and the acquiring company is to purchase a base run-off program containing at least Side-A and Side B coverage and to also purchase an excess DIC Side-A run-off program which affords coverage excess of the underlying full run-off program.

If Side B and/or Side C coverage is included in the run-off program, it is important to name the correct entity as the Insured Company in the policy. With respect to stock acquisitions pursuant to which the target company becomes a subsidiary of the acquiring company, the Named Company should be at least the target company. However, if the acquiring company is also obligated to indemnify the former directors and officers of the target company pursuant to the acquisition agreement, then the acquiring company may want to be added as an additional Insured Company with respect to that indemnification obligation.

If the acquisition is structured as a merger, and thus the target company disappears, the Insured Company in the run-off policy should be the acquiring company, but only with respect to prior Wrongful Acts of the target's directors and officers. The run-off policy should clearly recognize that no coverage is afforded for directors and officers of the acquiring company by virtue of the acquiring company being an Insured Company.

Which entities are included as Insured Companies can have a profound effect on the scope of coverage for the target's directors and officers under the run-off policy. Claims by an Insured Company are excluded from coverage pursuant to the insured v. insured exclusion. As explained above, claims by the acquiring company against former directors and officers of the target company for pre-acquisition mismanagement or misrepresentations present a serious exposure to those former D&Os, yet that exposure is probably excluded from coverage if the run-off policy includes the acquiring company (and perhaps the target company) as an Insured Company. Some broad Side-A policies do not contain this gap in coverage because their insured v. insured exclusion expressly does not apply to Claims made after a change-in-control. Although difficult to obtain, a similar carve-out to the insured v. insured exclusion should be sought if the run-off policy contains Side B and/or Side C coverages.

Another potential concern for the target's directors and officers if the run-off policy includes Side B coverage relates to the presumptive indemnification provision commonly contained in a D&O policy with Side B coverage. Pursuant to that provision, if the Insured Company is legally and financially able to indemnify the insured directors and officers, the relatively large Side B retention applies even if the Insured Company does not indemnify the directors and officers. In other words, if the Insured Company wrongfully refuses to indemnify the D&Os, then the D&Os must personally pay that large Side B retention before they can access coverage under the policy. Such a result can be disastrous for the former directors and officers. Given the potential conflict between prior management and new owners in the aftermath of a change-in-control, it is at least conceivable such a disastrous result could occur under a standard run-off policy.

Again, a broad Side-A policy cures that problem by not including a presumptive indemnification provision and, if written as an excess DIC coverage, by dropping down to pay the Side B retention in the underlying policy on behalf of the directors and officers (subject to the insurer's subrogation rights against the company for wrongfully refusing to indemnify the directors and officers). Although difficult to obtain, deletion of the presumptive indemnification provision in the Side B run-off policy should also be requested.

Yet another complication under run-off policies is the treatment of continuous wrongful acts which commence prior to the acquisition and continue after the acquisition. Because the run-off policy typically covers only wrongful acts taking place prior to the acquisition and the acquiring company's ongoing policy typically covers only wrongful acts taking place after the acquisition, the insurers of the run-off and ongoing policies, as well as the insureds, are usually required to negotiate a mutually acceptable allocation arrangement for losses resulting from continuous wrongful acts which span the acquisition date. Not surprisingly, it is often very difficult if not impossible to get all of the divergent parties to agree on such an allocation. In the absence of an agreement, the insureds are usually left with only a portion of their losses paid by the insurers, pending some type of dispute resolution process.

This allocation problem can be minimized if not eliminated in some instances by providing in one of the competing policies that all loss resulting from such continuous wrongful acts is covered under that policy and by providing in the other competing policy that all loss resulting from such continuous wrongful acts is excluded. In other words, the policies can place all of the loss in one of the policies and can exclude all of the loss in the other.

If the target company is a subsidiary being divested by the parent company, additional complications arise since the run-off coverage should be independent from and unaffected by both the selling parent company and the acquiring company. A claim for pre-acquisition wrongdoing may implicate both the run-off policy and the policy issued to the selling parent company. If the same insurer issued both policies, the insurer may insist upon a tie-in of limits provision between the two policies to avoid the insurer being exposed to a multiple limits loss for the same wrongdoing. Alternatively, if different insurers issue the policies, difficult allocation fights between the insurers regarding their respective obligations should be expected.

Companies are encouraged to analyze and negotiate with their D&O insurer(s) at least some of these issues before the M&A transaction arises. Because a crisis management atmosphere may develop once an acquisition is announced, waiting until that time before any of these issues are considered further increases that crisis atmosphere and potentially jeopardizes the quality and availability of an appropriate risk management response to the transaction.

About the Author:

Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

He can be reached at (614) 229-3213, or dbailey@baileycav.com.

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