Key Takeaways

Skadden

Evolving Minefields for Boards: Navigating Current Issues for Directors

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On June 24, 2015, Skadden held a seminar titled "Evolving Minefields for Boards: Navigating Current Issues for Directors" in Houston, Texas, to discuss certain challenging issues currently before boards of directors, and the management and outside advisers who guide them. Speakers included Skadden partners Peter Atkins, Frank Bayouth, Eric Otness, George Panagakis, Charles Schwartz and Erich Schwartz. Areas of focus were: (i) board governance and conflict issues in the context of M&A and restructuring, primarily from the target's perspective, (ii) regulatory, litigation and compliance activity updates, and (iii) emerging trends in shareholder activism.

Board Governance and Conflict Issues in the Context of M&A and Restructuring

Mr. Otness began this part of the seminar with an overview of directors' fiduciary duties of loyalty and care under Delaware law. These duties provide the source for concern about and analysis of whether directors are independent and disinterested. Mr. Atkins noted that there has been heightened focus over the past several years in Delaware M&A litigation on the existence, nature, treatment and consequences of conflicts (stemming both from financial interests and allegiance). The panel then discussed specific conflict issues that have arisen in the M&A context, involving company directors, CEOs and financial advisors.

CEO Conflicts

Mr. Atkins noted that, where the CEO is not conflicted, the board, while having a duty of oversight, has great latitude to delegate to the CEO the primary role of negotiating for the target. The rules of the game change, however, if the CEO is interested or lacks independence. In that case, direct, active disinterested, independent director involvement in the process is crucial, and the board may well decide that the CEO should not lead or participate at all in the negotiations. Mr. Atkins also discussed factors that a board should consider in evaluating possible CEO conflicts and determining the appropriate response to them.

Mr. Bayouth noted that even the acquiring company should be concerned about potential CEO conflicts in the merger context. For example, if a buyer offers the target CEO a post-merger employment or consulting agreement, the target board may view this negatively and remove the CEO from the negotiations. Moreover, the buyer may bear the risk of any perceived defects in the target's sale process, which could become an issue in the inevitable shareholder litigation seeking to prevent the transaction. Mr. Atkins noted that buyers often have a legitimate interest in ensuring the availability of the services of the target CEO following the closing, and that deferring any offer to, or discussions with, the target CEO until after the material economic terms of the transaction have been negotiated should substantially reduce or eliminate the risk of impairing the target's process.

Mr. Bayouth noted that, in some cases, boards seek to deal with potential CEO conflicts by creating a special committee to lead the negotiations. While a special committee is not required under Delaware law, creating one for merger negotiations can have certain benefits. Charles Schwartz discussed a number of these benefits, including that, in related party mergers in which the controlling shareholder takes out the other shareholders and the standard of judicial review is entire fairness, a properly formed and functioning special committee of independent, disinterested directors can shift the burden of proof in litigation challenging the transaction, from the defendants to the shareholder plaintiff. Mr. Schwartz also noted that such a committee, together with strict observance of a number of specific requirements set forth in recent Delaware court decisions, can shift the standard of review from entire fairness to the more deferential business judgment rule. Special committees in the merger context have become quite common in related party transactions and where issues of director or executive officer independence or disinterestedness are perceived. Mr. Atkins made clear, however, that merely creating a special committee was not a cure-all. In order to secure the protections offered by Delaware law, the committee must be active, vigilant and thoughtful throughout the process.

Mr. Panagakis noted that the same concerns about CEO conflicts apply — and may even be amplified — where a target is in a distressed situation.

Mr. Panagakis discussed how fiduciary obligations change as a company approaches insolvency. Under Delaware law, when nearing the "zone of insolvency," courts have found that a director does not breach his or her duty to the shareholders by also beginning to take into account the impact of decisions on the company's creditors. Additionally, once a company becomes insolvent, those creditors may seek standing to sue the directors derivatively on behalf of the company for breaches of fiduciary duty. Regarding conflicts, Mr. Panagakis noted that the main source of additional conflict in a distressed situation is the pressure it creates on management, which is operating in the midst of a financial crisis and does not have the healthy company incentives toward long-term value enhancement that it normally would. This can lead to "management fatigue," with a focus on departure rather than the difficult task of preserving value while battling competing interests on multiple fronts or engaging in a quick de-leveraging transaction that may not be in the best interests of shareholders who wish to weather the storm. Because of this, in a distressed situation, boards often need to spend more time with management to maintain their motivation, interest and desire to lead the company through difficult times.

Director Conflicts

Mr. Bayouth noted that potential director conflicts of allegiance can arise where a director has ties to a large shareholder of the target. If the director owes a fiduciary duty to the large shareholder (*e.g.*, as a director or officer) or is otherwise not independent vis-à-vis the shareholder (*e.g.*, due to a strong business relationship tied to the shareholder), the director should consider whether the shareholder has any role in the proposed transaction or motivations to sell its stake for reasons other than value maximization. If so, the director should report the potential conflict to the target and expect to be recused from consideration of the matter at hand. Mr. Atkins noted that directors also should be alert to whether they would receive any special compensation from their shareholder nominators if the target engages in the proposed transaction (an arrangement that has been implemented in a few activist hedge fund situations), which creates an economic incentive for the director to approve a transaction that may not be aligned with the interests of shareholders.

Banker Conflicts

Investment banker conflicts is an area of law that has received significant attention lately. Mr. Bayouth noted that one reason relates to the role of the banker in providing a fairness opinion in M&A transactions. The fairness opinion is designed to assist the board in satisfying its duty of care. If the banker giving the opinion is conflicted, this easily could affect the reasonableness of the directors' reliance on the opinion. Mr. Bayouth also discussed other important areas of advice that an investment banker often provides to a board of directors in connection with an M&A transaction, including advice with respect to strategic alternatives, potentially interested parties, the ability of a bidder to execute its proposal, and various negotiating tactics and positions, and noted that a board's ability to rely on that advice also could be impaired by the existence of a banker conflict. Charles Schwartz discussed some of the adverse litigation outcomes that could arise where a banker is conflicted and the board fails to discover or deal with that conflict. Mr. Schwartz and Mr. Atkins both noted that this is a rapidly evolving area of the law; indeed, two cases involving banker conflicts are currently pending, one on appeal to the Delaware Supreme Court (*Rural Metro*) and the other at an early motion stage in the Delaware Court of Chancery (*PLX Technology*). Mr. Atkins discussed various types of potential banker conflicts that have been raised as issues in litigation challenging transactions.

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Duties in the Context of Alternative Entities

Under Delaware law, alternative entities such as limited liability companies or limited partnerships have tremendous flexibility to limit or even eliminate most fiduciary duties, with the exception of the duty of good faith and fair dealing. Mr. Panagakis discussed a number of issues that arise with these types of entities. In situations where such an entity is managed by another entity, courts in Delaware and other states have been willing to look up the chain and apply fiduciary duties owed at a subsidiary level to the ultimate decision-makers, notwithstanding the apparent limitation on duties in place at the top-tier entity.

Update on Regulatory, Litigation and Compliance Activity

Erich Schwartz provided an update on regulatory, litigation and compliance activity. Mr. Schwartz observed the impact that volatile oil and gas prices can have on judgmental elements of a company's financial presentation, such as valuation and impairment determinations, reserve assessments and liquidity disclosures. Mr. Schwartz noted the challenge of assessing the consequences of disruptions to settled expectations regarding commodities prices is heightened because the Securities and Exchange Commission's (SEC) Division of Enforcement recently has been refocusing its investigative enforcement resources on accounting and disclosure matters after a period of decline in such enforcement activity during the financial crisis. As part of that effort, the Enforcement Division has organized a Financial Reporting and Audit Task Force, which uses sophisticated data mining techniques, including an Accounting Quality Model, developed by the SEC's Division of Economic and Risk Analysis to identify targets of investigative interest. A consequence of that effort has been a series of "green field" investigations commenced in the absence of any apparent indication of improper activity. Mr. Schwartz discussed proactive steps to avoid the SEC's attention, including ensuring that accounting policies are appropriate and sufficiently comprehensive, and that the policies are reasonably and rigorously applied. He also described approaches to such inquiries that can be successful in bringing them to an early termination.

Mr. Schwartz discussed the whistleblower and anti-retaliation provisions of the Dodd-Frank Act, and the impact of those provisions on companies in maintaining effective compliance programs and in responding to particular instances of potential misconduct. In particular, companies conducting investigations and assessing self-reporting must be mindful of the possibility that company personnel, including personnel charged with compliance responsibilities, may separately be communicating with regulators.

Regarding the Foreign Corrupt Practices Act (FCPA), Mr. Schwartz noted that the FCPA remains an intensely active program area for both the SEC and Department of Justice. One characteristic of the FCPA is that the substantive law is advanced almost entirely by settlement, so there are few judicial constraints on the government's ability to develop novel theories of potential liability. Emblematic of that are public reports of recent investigations that focused on circumstances where companies have placed persons (including, reportedly, children of government officials) in internships at the request or recommendation of government officials.

Emerging Trends in Shareholder Activism

Finally, Mr. Atkins highlighted certain aspects of the burgeoning phenomenon of shareholder activism (both financial return- and corporate governance-related). He noted that activism is the most pervasive subject facing U.S. public companies today. Mr. Atkins commented that size alone is no longer an assured protection from financial return activists, citing as examples Apple and DuPont. Mr. Atkins cautioned that it is critical for companies to prepare in advance for the possibility that they may be the target of an activist initiative and that, as part of this preparation, it is important for boards to think about their companies as if the directors were activists seeking to extract more value. Mr. Atkins referenced Skadden material relating to advance planning for and responding to possible activist initiatives that was provided to the seminar attendees.