Governance Challenges 2016: M&A Oversight

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M&A Rates in 2015 Reach Record Levels and Litigation Stabilizes: What Directors Should Know

Marsh & McLennan Companies

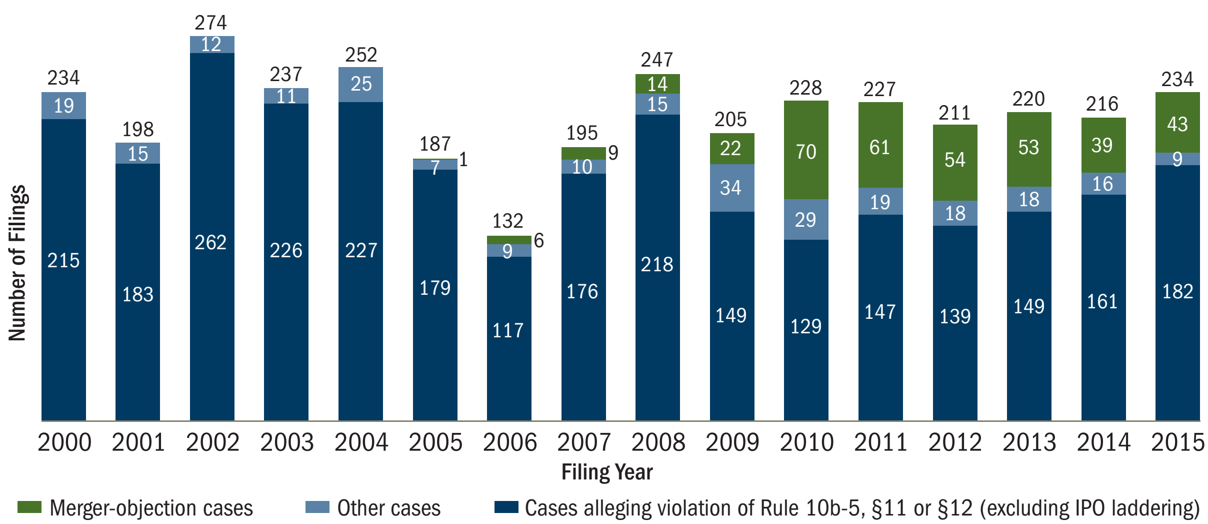
Current Landscape

Mergers and acquisitions (M&A) of all sizes drove approximately $4.7 trillion in deals in 2015, just below the 2007 record of $4.9 trillion. Activist shareholders, abundant cash, desire for tax relief, cheap debt, ROI pressure, and fierce global competition fueled consolidation in many industries with healthcare, technology, and telecommunications in the lead for large deals ($10B+). U.S. volume led large deals in 2015 at $1.4 trillion. Europe, the Middle East, and Africa (EMEA) came in next with $301.2 billion, with Asia following at $171.8 billion. The fast pace of M&A activity is expected to continue into early 2016 at least, along with rising collateral risks for public companies and personal assets exposure for global corporate directors.[1]

Merger Litigation

After a period of more than five years during which virtually every deal valued at over $100 million was challenged by plaintiffs bringing merger-objection suits at both the federal and state levels, the rate of such litigation has begun to slow. According to a NERA Economic Consulting report released in January 2016, the filing of merger-objection suits in federal court peaked in 2010 with 70 cases filed (see Figure 1). Since then, filings have continued to fall, with just 43 filings made at the federal level in 2015. This drop is in spite of a record volume of announced U.S. mergers and acquisitions in 2015. What happened?

FIGURE 1: **FEDERAL FILINGS BY TYPE, JAN 2000–DEC 2015**



NOTES: Before 2005, merger objections (if any) were not disaggregated. This figure omits IPO laddering cases.

SOURCE: NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review*, Jan. 25, 2016.

[1] Tony Li, "Global $10bn+ M&A Volume and Activity Sets New Record in 2015 YTD," *Dealogic*, Dec. 18, 2015.

While the chart in Figure 1 illustrates the filing activity for merger-objection suits at the federal level, Figure 2 shows that plenty of activity has been churning for years across multiple jurisdictions at the state level. The slowdown in filings started in the fall of 2015, when the Delaware Chancery Court denied plaintiffs the ongoing ability to file disclosure-only merger-objection lawsuits, meaning suits that deliver no monetary benefit to shareholders who seek non-material supplemental disclosures for a broad release of claims and payment of attorney fees. At the same time, multi-jurisdiction litigation is on the wane as more and more state courts have, like the Delaware Chancery Court, chosen to uphold organizations' ability to include forum selection provisions in their bylaws, designating Delaware as the exclusive forum for shareholder litigation. This trend should not be considered a panacea, however, as plaintiffs may seek friendly jurisdictions outside of Delaware. Plaintiffs are also becoming more creative about finding ways to bring claims that might be litigated after a deal closes. At the same time, companies may choose not to enforce forum selection provisions in particular cases.

FIGURE 2: **LITIGATION RATES OVER TIME**

	Deals	Litigation	Percentage with litigation	Mean number of suits per case	Percentage of multistate claims
2005	183	72	39.3%	2.2	8.3%
2006	232	99	42.7%	2.6	26.3%
2007	249	97	39.0%	3.1	21.9%
2008	104	50	48.1%	2.8	30.0%
2009	73	62	84.9%	4.6	41.9%
2010	150	131	87.3%	4.7	46.6%
2011	128	117	91.4%	5.0	53.0%
2012	122	112	91.8%	4.8	53.6%
2013	118	110	93.2%	4.8	41.8%
2014	137	130	94.9%	4.4	36.2%
2015	73	64	87.7%	3.6	23.4%
Total	1,569	1,044	66.5%		

For fiscal 2015, completed-transaction M&A litigation declined to 2010 levels. Multijurisdictional litigation has been decreasing since its peak in 2012 and is now approaching 2007 levels.

SOURCE: Matthew D. Cain and Steven Davidoff Solomon, "Takeover Litigation in 2015," preliminary figures (Berkeley Center for Law, Business and the Economy, Jan. 14, 2016)

Directors' Basic Duties

The majority of merger-objection filings involve shareholder litigation against directors. Concerns about corporate directors' personal exposure in this regard involve the likelihood of allegations against them for breaches of the fiduciary duties owed to shareholders, including duties of care and loyalty. The review standard used by the court to evaluate directors' fulfillment of these duties is called the Business Judgment Rule. It prohibits penalizing directors for what shareholders may consider poor outcomes from events like corporate transactions so long as the directors exercised adequate diligence without conflict of interest. Essentially, the court cannot second-guess a director's judgment if the director has satisfied the duties of care and loyalty.

Myriad Exposures

Risk is inherent in corporate acquisitions. An organization's ability to identify and mitigate such risk is critical to a successful transaction. In fulfilling their fiduciary duties, corporate directors have an enormous responsibility to make sure that a potential transaction is in the best interests of shareholders and is valued fairly. On the buy side, the board should ensure that a particular acquisition is a strategic and cultural fit based on a detailed understanding of the target company's business. On the sell side, directors' ability to set the tone and process for selling the company, or part of it, in order to maximize stockholder value will determine how vulnerable the board is to litigation.

Select exposures that may result in litigation against an organization and its board pursuant to a transaction include the following risks:

- Financial management quality
- Cybersecurity
- Environmental liability
- Intellectual property liability
- Antitrust liability
- Operational efficacy
- Product viability
- Underlying vulnerability
- Motivation to sell
- Contingent liability (arises after a transaction closes)

Uncovering risk is a significant part of senior management and the board's due diligence when evaluating potential M&A deals. The ability to categorize identified risks as threats and opportunities is critical for the board in recommending whether to retain, manage, or transfer risk when approving a strategic transaction.

Personal and Corporate Protections

Directors and their organizations have several protections available to help offset or even eliminate risk and personal exposure almost entirely in M&A. First, directors are typically protected by advancement and indemnification provisions in corporate bylaws. In addition, many directors choose to maintain their own personal indemnification agreement with the organization (which can be modified or terminated only by the indemnitee—unlike provisions in corporate bylaws).

Next, most public companies buy large Directors & Officers (D&O) liability insurance programs that provide protection for individual directors and officers against claims for which they cannot be indemnified; for the corporate balance sheet for amounts used to indemnify individual directors and officers; and, finally, for the corporate entity as a defendant but only in securities-related claims. In most cases, a director's personal liability for M&A exposures is minimized through a combination of indemnification agreements, bylaw provisions, and customized D&O insurance (all D&O policies contain an exclusion for fraud and dishonesty while preserving the right to advancement of defense costs subject to a final adjudication).

But what about exposure arising from the M&A deals specifically? Traditionally, transactional risk insurance was used to protect against risks related to inadequate due diligence, but it is now being deployed globally by buyers and sellers as a key component of M&A transactions.

Private equity funds, public companies, and individuals all benefit from transaction risk coverages, including representations and warranties, tax indemnity, and contingent liability insurances. Representations and warranties insurance covers all representations and warranties indicated in the purchase agreement. It protects against financial loss, including defense costs resulting from breaches of the reps and warranties made by a target company or the selling company in a purchase agreement. The named insured on the policy can be the buyer or the seller (but not both), and it offers the following advantages in protection and deal facilitation:

- protection beyond the negotiated indemnity cap and survival periods in a purchase agreement;
- allowance for buyers to distinguish a bid in an auction (e.g., requiring only minimal or no survival of the reps and warranties in a bidder's draft purchase agreement);
- protection against collectibility/solvency risk of an unsecured indemnity (financially distressed, non-U.S. or multiple sellers); and
- preservation of key relationships by, for example, eliminating the need for a buyer to pursue claims against management sellers working for the buy post-close.

For sellers, reps and warranties insurance offers the following select benefits:

- backstops negotiated indemnity obligations (key for private equity funds or venture capital funds at the end of their life cycle);
- protects minority/passive sellers concerned with joint and several liability; and
- furnishes a solution for situations where there is a lack of ownership history (e.g., restructurings, "loan to own").

Tax indemnity insurance is used in the event a taxing authority challenges a historical tax position taken by the target organization and which is either assumed by the buyer or retained by the seller via an indemnity. It can also be used to insure a particular tax structure in the transaction. Tax indemnity insurance is most often deployed when the likelihood of the relevant potential tax liability is low, but the potential amount of liability is so substantial relative to the size of the transaction that the parties cannot agree on escrow or indemnification for the issue. The policy generally covers the tax liability (to statute limits), fines and penalties, interest, legal costs, and tax gross-up. Select exposures insured under tax indemnity insurance include the following risks:

- Successor liability
- Tax credit recapture risk
- Net operating losses
- S-corporations/maximizing tax benefits under tax code 338(h)(10)
- Capital gains *vs.* ordinary income
- Tax-free reorganizations
- Cancellation of indebtedness
- FASB Interpretation No. 48 (FIN 48).

Contingent liability insurance covers one-off, known exposures in M&A transactions where a claim may surface immediately or sometime in the future after the closing of a deal (unlike reps and warranties insurance, which does not cover known issues). Areas of potential coverage include

- fraudulent conveyance,
- successor liability,
- open-ended indemnities, and
- potential litigation risk.

In Summary

The near-record pace of transactions in fiscal 2015 is expected to continue into early 2016 at least. The litigation landscape has recently stabilized with respect to M&A, but the plaintiffs' bar is creative, and there is no guarantee that merger-objection suits will subside entirely—particularly at the state level. Both indemnification agreements and corporate indemnification provisions along with D&O insurance can provide significant protection against personal exposure for corporate directors when exercising their fiduciary duties toward shareholders. Transactional risk insurance facilitates M&A activity in support of continued corporate consolidation, competitiveness, and growth. Transactions, mergers, acquisition, and divestitures all carry risk. Corporate directors and their organizations have an obligation to identify these risks and convert them, when possible, into opportunities that will drive shareholder value. The good news for directors when it comes to personal exposure in executing their duties in M&A is that they have several alternatives at their disposal to help mitigate and transfer that risk.

Directors may wish to consider the following questions:

- How acquisitive is our organization likely to be over the next 12 to 18 months?
- Have we adopted forum selection bylaws?
- Have we evaluated transactional risk insurance alternatives in the past?
- When were our corporate indemnification provisions last updated?

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