Holding back the tide of M&A litigation

Steps that can protect directors and minimize their exposure.

BY DOUG RAYMOND

Experienced directors know that a risk in acquiring or selling any public company is that an unhappy or simply litigious shareholder may file a lawsuit against the company or its directors complaining about the transaction. Directors may not, however, understand how dramatically the number of such cases has increased over the past several years. According to a recent report published by the Securities Class Action Services, there has been a 500% increase in deal-related lawsuits filed in 2010 over 2008 and a 700% increase over 2006.

This eye-popping rise in litigation is partially attributable to the recent recovery in deal activity generally and may also be a delayed reaction to deals cut at bargain basement prices during the recession.

The increase also reflects developments over the last several years in the plaintiffs' bar and a general broadening of the types of cases they are bringing. Indeed, even as deal litigation has become more prevalent, companies are often eager to settle these cases quickly to maintain momentum on the deal (and are often insulated from the effects of the settlement thanks to their D&O insurance coverage). This permits the plaintiffs to achieve a recovery without spending years in expensive litigation.

The increase in litigation has been coupled with a decrease in the size of the companies targeted. According to a recent report, in 2006 the median market cap of a public company involved in a merger or acquisition that became embroiled in a lawsuit was $1.1 billion; by 2010 the median market cap had fallen to $509 million.

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The number of these cases is only going to increase in the coming years. In general, these challenges tend to come in one of three flavors: (1) breach of duty of care by the target company's directors, generally based on failure to obtain adequate deal value, insufficient shopping of the acquired company, or improper agreement to preclusive deal terms, such as too high a termination or break-up fee, (2) breach of duty of loyalty by the target company's directors, based on a claim the directors had a conflict of interest in approving the transaction, or (3) lack of adequate disclosure in the SEC filings related to the transaction, such as regarding the methodology used in the fairness opinion or failure to provide adequate information about projected future performance.

While any litigation can be burdensome, it is, increasingly, simply a cost of doing a transaction. And, although the risk of litigation is certainly not a reason to avoid a deal, there are a number of steps directors can take to help protect themselves and minimize exposure to potential litigation, including:

- Taking the normal precautions recommended in any deal, including giving consideration to all the viable alternatives and actively considering other potential transactions, as well as other buyers, if appropriate; fully negotiating the transaction; obtaining a fairness opinion on the transaction consideration; and taking the time to carefully and impartially evaluate the transaction.
- Consulting with good legal and financial advisors who are not burdened by conflicts of interest.
- Using a carefully chosen special committee of disinterested directors, if necessary to avoid conflicts or even the appearance of a conflict.
- Keeping good records, including board minutes, while being careful to avoid poorly considered, inconsistent or potentially confusing notes (including individual director notes or e-mails, which generally should not be retained).
- Being sensitive when relying on a fairness opinion given in connection with the deal, particularly if it will be given by the same bank that stands to collect a sizable fee only if the transaction closes.

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- Negotiating meaningful protections to permit the board of the target to exercise its fiduciary obligations to seek or respond to a better offer.

Many anticipate a further increase in the volume of M&A deals this year, and there is no indication that there will be a drop in the corresponding litigation. Although there is no protection against deal litigation, taking precautions such as those outlined above can go far in helping to settle these cases more quickly and for less money. Perhaps more important, these can lead to a better process and outcome for all. ■

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