Buy-side Directors and Risk Management in M&A

Abstract

Risk and value creation are closely related concepts. M&A may provide companies with an opportunity to grow, capture synergies, or accomplish other strategic objectives that can create value, but most transactions fail to accomplish their stated objectives. While the reasons behind the success or failure of a particular transaction depend on the circumstances, risks like incorrect valuation, adverse changes in the economy after the deal closes, failure to capture synergies, and inefficient post-merger integration are generally applicable M&A-related exposures that can destroy value in any transaction. Regardless of how advantageous a deal appears on paper, optimum performance depends on an acquiring board’s ability to evaluate, plan for, and manage risk in all stages of the transaction. Effective risk management requires the board to accurately value a target, to account for factors that increase the likelihood of failure, and to shape a merger plan that supports efficient integration and synergy capture. In this way, the Board of Directors and other officers play a vital role in determining whether M&A activity will create or destroy shareholder value.

Valuation, Merger Waves, and Risk Management through Deal Structure

About half of M&A transactions fail to accomplish the objectives stated when the deal is announced, and an estimated 67-75% of M&A transactions fail to create additional value. Historically, acquiring companies have experienced a drop in share price after plans for a deal are made public. Presumably, this decrease demonstrates the market’s recognition of the fact that M&A generally fails create to value. However, in more recent years this trend has reversed, and this year companies have seen an average 4.4% increase in share price shortly after a transaction has been announced. But regardless of whether a deal accomplishes a strategic objective or whether share-price increases in the short-term, M&A can only create value if the benefit of a transaction outweighs the cost of obtaining that benefit. While accomplishing a strategic objective may create value, over-paying for a target can only reduce the up-side value a transaction can represent for an acquirer. Therefore, the likelihood that a transaction will create value cannot be understood without a concrete understanding of the potential margin, and while synergy capture and accomplishing strategic objectives can create value for shareholders, evaluating that potential value creation starts with an accurate valuation of the target.

Even if an accurate valuation shows that a transaction has the potential to create value, future market conditions often determine whether the deal will be a success. The cyclical nature of M&A activity is certainly the result of many factors, but these merger waves illustrate how market confidence influences M&A, and also highlights the importance of accurate valuation and risk management. Since 1893 there have been six complete merger waves. The last complete M&A wave began in 2003 and peaked in 2007, a year in which global M&A deals were worth a record $4.83 trillion, up nearly 24% from the previous record ($3.9 trillion) set in 2006. This wave ended with the financial crisis of 2008, a year in which stock markets fell nearly 50%.
While the value of M&A activity has recovered since 2008, if past market patterns are any indicator, the market may currently be at the crest of a seventh merger wave. In 2013, global M&A deals had a collective value of $2.91 trillion, up 9% from 2012. The U.S. M&A market has also surged since 2008. In 2013, the collective announced value of U.S. M&A deals was over $1.1 trillion, an increase of 28% from 2012. The increased value of M&A activity has continued to increase into 2014. Through April 2014, the value of global M&A deals was about $1.2 trillion, an increase of 42% over the first four months of 2013 and nearly matching the $1.4 trillion value in the first four months of 2007.

But while the value of M&A activity has increased, the number of deals has decreased. For example, the 9% increase in total value from 2012 to 2013 was in spite of a 15% decrease in the number of deals completed. This decrease may indicate that directors are wary of another economic downturn, but it also indicates that the average value of each transaction is increasing. So far this year, M&A transactions have an average value of over $200 million, nearly matching the average deal value from 2007. Notably, an above average 13 deals worth $10 billion or more have closed in the first four months of this year, and deals worth $5 billion or more accounted for half of the total value through the month of March.

The rising price of M&A may simply be a function of rising stock prices, but the currency structure used in the most recent wave of M&A activity has evolved. In the first four months of 2007, approximately 76% of all M&A transactions were cash-only, 8% were stock-only, and the remaining 14%-16% were a combination of both. In contrast, in the first four months of 2014, 47% of the M&A market has been cash-only, 19% of deals have been paid for with stock, and about a third of all deals have been financed with a combination of both. By paying with stock, acquirers may overpay if their stock is undervalued. While rising stock prices may mitigate this risk, what is interesting about the use of stock in the current wave of M&A activity is that U.S. companies had cash reserves of approximately $1.64 trillion at the end of 2013. Despite this record amount of cash, acquiring companies may see their stock price as being overvalued. Therefore, by paying with stock instead of cash, acquiring boards may be able to “bridge the gap” with a selling company’s valuation while hedging against overvaluation or future underperformance due to failure to capture synergies or economic downturn.

Post-Merger Integration Risk and Merger Success Rate

Regardless of the economic forecast, the type of currency used to acquire a target, or the value a deal can potentially create, optimal deal performance is ultimately a function of a company’s ability to preserve value after the deal closes. In M&A, where an outside organization becomes part of, or controlled by, an acquiring company, fact-specific analysis of post-merger integration (PMI) risk is necessary to fully understand the cost of a transaction. This type of PMI risk analysis in due diligence is a complex task that goes beyond a mere financial and cost-
benefit evaluation, but identifying and planning for these variables provides a clearer picture of a deal’s potential to accomplish its intended purpose and create value.

While some sources identify issues like technology integration and culture clash as reasons why M&A fails, consideration of generalized terms should be distinguished from in-depth transaction-specific risk analysis. In 2010, Deloitte released an empirical analysis of the relationship between the types and level of post-merger integration (PMI) risk and the likelihood that a merger will fail. Out of 300 potential factors, this study identified 35 primary factors which fall into four main categories of risk that materially influence the likelihood of PMI failure.

The four primary PMI risk categories of are: 1) Synergy risks that arise from poor synergy realization planning, 2) Structural risks which stem from poor organizational fit, 3) People risks which relate to employee resistance or departure as a result of the transaction, and 4) Project risks, which are risks that relate directly to management’s ability to effectively manage PMI after the transaction. Because PMI success is defined by value preservation, rather than creation, these risk factors all relate to areas that can potentially destroy value after a deal closes.

These four primary risk categories have multiple subcategories which are comprised of multiple factors that determine the level of risk attributed to that particular category. There are three subcategories of Synergy risks:
   a) quality of financial figures;
   b) complexity of synergy goals; and
   c) execution of plan viability.

The two Structural risk subcategories are:
   a) organizational and managerial differences; and
   b) business process heterogeneity.

There are three subcategories of People risk:
   a) realignment at the executive level;
   b) changes at the managerial level; and
   c) the extent and direction of downsizing.

Finally, the two subcategories of Project risks are:
   a) lack of expertise; and
   b) limited human resource capacity.

Analysis of these data points provides clear evidence of the relationship between the level and category of PMI risk, the likelihood of preserving value through PMI, and ultimately, whether the merger will be a success. 35% of the M&A transactions evaluated were classified as having low PMI risk. These transactions have only low to moderate levels in all four of the primary risk categories; and, according to the study, PMI in these low risk deals successfully preserves value 75% of the time. The second most successful type of M&A have high Synergy and Project risks, but only low to moderate Structural and People risks. This risk profile makes up 17% of all M&A, and PMI is successful about 27% of the time. The third risk profile, in which only Synergy risks are low to moderate and Structural, Project, and People risks are all high, makes up almost a third of all M&A. Under these circumstances PMI successfully preserved value in only 17% of the cases evaluated. The last risk profile is seen in situations
where all four categories are high risk. While this risk profile was the least prevalent, accounting for only 16% of the cases evaluated, PMI successfully preserved value in only 1% of these high risk situations. These statistics are represented graphically below.

Overall, the PMI success rate of the cases evaluated was only 36.44%. This means that in over 63% of these cases, the deal did not meet expectations or destroyed value because PMI was not successful. While this average PMI failure rate is more conservative than the previously mentioned estimate that 67%-75% of M&A fails to add value, a more important observation is the dichotomy between the success rates of low risk M&A and every other, higher risk profiles. If the data set is representative of M&A as a whole, only 35% of M&A transactions are classified as low risk. While these transactions have a relatively high success rate of 75%, only 15.67% of the remaining 65% of M&A have successful PMI. Thus, while it is generally correct to state that most of mergers fail to create value, a more accurate statement is that about 85% of almost two-thirds of all M&A transactions fail to create, or destroy value.

The Role of the Board of Directors in Buy-side Risk Management

The rate of M&A failure, both in accomplishing strategic objectives and in adding value, is both interesting and alarming. As shown above, the risks associated with a transaction can be identified and, to some extent, quantified. Prudent evaluation of a target not only requires an accurate valuation, it also involves developing a risk profile of the target to determine the likelihood that the deal will ultimately succeed. The Deloitte study shows that higher-risk transactions, in which the target has higher PMI-risk profile, comprise the majority of M&A. Because M&A with high PMI risk succeeds, at most, only 27% of the time, the logical conclusion is that these transactions are not prudent. But if due diligence is a routine part of a transaction, why is high-risk M&A activity so prevalent?

The simplest answer is that acquiring directors face a great deal of pressure to create value and are afforded a great deal of discretion in how they approach M&A and other business decisions under the business judgment rule. A basic principal of corporate law is that the business and affairs of a corporation are managed and directed by the Board of Directors. See 8 D.G.C.L. § 141(a); N.C.G.S. § 55-8-01(b). This broad grant of authority includes the power to initiate M&A, See 8 D.G.C.L. § 251(b); N.C.G.S. § 55-11-03(a), and buy-side shareholder approval is generally not required unless 20% or more of the acquirer’s shares are being issued in the transaction. See 8 D.G.C.L. § 251(f).

In exercising their discretion, directors must uphold their fiduciary duties of care and loyalty. In general terms, the duty of loyalty requires directors to act on behalf of the corporation and to refrain from self-dealing or taking corporate opportunity. The duty of care requires
directors to act in good faith, with the care that a reasonable person would exercise under similar circumstances, and in the best interests of the corporation. See e.g., N.C.G.S. § 55-8-30(a). If a Board acts within its authority and in compliance with their fiduciary duties, their business decisions are protected by the business judgment rule, which as explained by the Delaware Supreme Court is “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”

Rebutting this presumption is difficult and, where it applies, courts will usually not interfere or hold directors liable for any losses that result from board decisions. But while this protection extends to a board’s good faith M&A decisions, the high percentage of M&A that fails due to high PMI risk presents an interesting question regarding the duty of care. In contrast to the high success rate of M&A where PMI risk is low, if one assumes that all boards uphold their duty of loyalty and that there are no outside factors that materially impact one deal’s success more than another, the frequency of M&A activity in which the target has a high-risk profile is surprising. The fact that such a low percentage of these transactions are successful makes relevant the question of whether directors who engage in high-risk M&A are acting “with the care an ordinarily prudent person in a like position would exercise under similar circumstances.” The implication being that directors who undertake high-risk M&A activity without first identifying the transaction as being high-risk (and therefore having a low likelihood of success) have not complied with their duty of care. However, while the close evaluation of a target’s PMI-risk profile evaluation would likely be beneficial, courts have deferred to the M&A decisions of acquiring directors under the business judgment rule.

*M&A “Failure” vs. Long-term Benefit and Risk Tolerance*

While the interests of some shareholders may be frustrated by the failure of high-risk M&A, perhaps the deference given to buy-side boards is justified. One reason for protecting a board’s good faith business judgment is that the board may have a long-view of the corporation’s best interests. In *Dodge v. Ford Motor Co.*, the Michigan Supreme Court held that “a business corporation is organized and carried on primarily for the benefit of its stockholders,” and that “the powers of the directors are to be employed for that end.” But while “the discretion of directors is to be exercised in the choice of the means” of maximizing shareholder profits, their duty is to act in the “best interests of the corporation.” An example of Delaware’s formulation of this duty is found in *eBay Domestic Hldgs., Inc. v. Newmark*, where the Delaware Chancery Court stated that the directors of Delaware corporations have the legal responsibility “to promote the value of the corporation for the benefit of its stockholders.”

This responsibility is not limited to a duty to act merely in the way that produces the most immediate value. Courts have also held that the interests of shareholders “are congruent with those of the corporation in the long run.” Therefore, while a high percentage of M&A fails to create the immediate value, some transactions may still be in a corporation’s best long-term interests even if the transaction destroys short term value. For example, the cost of acquiring an up-and-coming competitor at a premium may outweigh any instant benefit for the acquirer but, if the target competitor could potentially diminish the acquirer’s market share or profitability in the future, the transaction may be necessary to protect the acquirer’s long-term interests.
Because shareholders will ultimately benefit from actions that benefit the corporation, courts do not impose a “duty to maximize profits.” For this reason, directors do not have a duty to act maximize short-term stock prices, and courts will not interfere with business decisions that are made in good faith and in the best interests of the corporation, even if those decisions have destroyed shareholder value in the short term. The ability to consider a corporation’s long-term interests, rather than merely the immediate maximization of shareholder value, is particularly important in cases where the short-termisms of offensive shareholder activists are not congruent with the board’s judgment of what is best for the corporation. In this way, the protection of the business judgment rule allows directors to facilitate a corporation’s competitiveness and long-term financial viability.

In addition to any long-term strategic considerations that may justify a transaction, another justification for protecting board discretion in high-risk M&A activity is the right of public shareholders to exit the company. The modern corporation is an efficient method of capital formation, but some investors, like some directors, are more risk tolerant than others. Thus, where buy-side directors have aggressively pursued M&A as a method of growth and value creation, some shareholders may be uncomfortable with the board’s strategy. In this case, public shareholders who are more risk adverse can sell their shares if they do not agree with the board’s judgment. While exit, or threat of exit, may be a form of shareholder activism, in this context it is simply a matter of strategic differences. Therefore, because shareholders can align, or divest, their capital according to their risk appetite, the board should exercise their discretion as to how to maximize profits for those shareholders. This strategy may include aggressive M&A, and courts will not question the negotiations or business judgment of independent and disinterested directors.

But this justification for the deference given to a buy-side board’s M&A decisions relies on the continued ability of the acquirer’s shareholders to exit the corporation. Following the Delaware Supreme Court’s holding in Revlon v. MacAndrews & Forbes Holdings, when it is foreseeable that a target will be subject to a change of control for the target or that the target’s corporate identity will cease to exist, the target board’s duty shifts to that of maximization of the value obtained for the shareholders. While Revlon duties attach in situations where a corporation is acquired in a takeover or merged into an acquirer, in Gaines v. Narachi, the Delaware Chancery Court held that “Revlon…only applies when…the corporation seeks to sell itself or when the proposed transaction would result in a sale or change of control.” Thus, even where an acquirer’s shareholders are required to approve the purchase of a target in a stock-for-stock transaction, there is no “Revlon moment” which would prompt heightened scrutiny because the buyer is not “selling itself.” Therefore, where there will be continuity of the acquirer’s corporate identity and no sale of control, the M&A decisions of buy-side directors are given deferential business judgment treatment because Revlon duties do not apply.

**Buy-side Directors and the Duty to be Informed**

The reasons above may be accompanied by other justifications for deferring to the business judgments of directors who act in accordance with their duties to the corporation. Ultimately, the reasoning behind this deference is that where there is no evidence that directors were breaching their fiduciary duties, the board of directors is in a better position than the court to make business judgments. In In re Caremark International Inc. Derivative Litigation, Chancellor Allen explained that “…compliance with a director's duty of care can never
appropriately be judicially determined by reference to the content of the board decision that leads
to a corporate loss, apart from consideration of the good faith or rationality of the process
employed.” The “rationality of the process employed” speaks directly to the duty of care.

In Smith v. Van Gorkom, the Delaware Supreme Court held that “directors have to act in
an informed and deliberate manner in determining whether to approve an agreement of
merger....” While this case, and most of the other case law that addresses the role and fiduciary
duties of the board in M&A, focuses on the decision-making of sell-side directors, the duties of
care and loyalty also apply to the conduct of an acquiring board. Therefore, while the business
judgment rule protects M&A decisions that are made in good faith (i.e., where the directors
believe that there is at least some likelihood of success), a board’s failure to inform itself of those
risks may be a breach of the duty of care.

The Van Gorkom Court also provided that “…the concept of gross negligence is…the
proper standard for determining whether a business judgment reached by a board of directors
was an informed one.” Gross negligence is defined as “conscious and voluntary disregard of the
need to use reasonable care, which is likely to cause foreseeable harm...to property.” In light of
the percentage of mergers that fail, and because it is foreseeable that a failed deal could harm to
the corporation, application of the rule from Van Gorkom to the M&A decisions of directors in
acquiring corporations would impose a duty to use reasonable care in evaluating whether a
transaction can succeed. Further, while the approval of buy-side shareholders is not required in
cash-settled transactions, the fact that more stock is being used to acquire targets in the current
wave M&A leads to a higher probability that the approval of these shareholders. In a situation
where buy-side directors are required to obtain shareholder approval under 8 D.G.C.L. § 251(f),
the issue of whether a board’s recommendation to shareholders is an informed business judgment
may particularly relevant. Accordingly, if the Van Gorkom rule applies to situations where the
Board has not adequately informed itself about a target’s risk, an uninformed recommendation to
shareholders would also be a violation of the duty of care.

Whether directors have used “reasonable care” to inform themselves of risk depends on
the circumstances. In Van Gorkom, the board breached its duty of care when it took substantially
no action to inform itself. Following Van Gorkom, it became common practice for sell-side
directors to rely on investment bank fairness opinions as a way of showing that a transaction was
a matter of informed business judgment. While directors may rely on the advice of experts so
long as their reliance is reasonable and in good faith, See 8 D.G.C.L § 141(e), a sell-side board’s
duty to inform itself is not satisfied merely by relying on investment bank fairness opinions.

A recent case, In re Rural Metro Corp. Stockholders Litigation, may have implications
for buy-side directors if their reliance on investment bank advice is unreasonable. Like Van
Gorkom, the litigation in In re Rural Metro was the result of a target board who made an
uninformed decision to sell. The Chancery Court characterized investment bank advisors as
“gate keepers” in the M&A process who, unlike directors, have the expertise to value a
corporation, as well as the time and ability to design and carryout a sale process. For this reason,
the Chancery Court held that expert advisors can and should be held liable for aiding and
abetting the inducement of “directors to breach their duty of care.”

While the relevance of this case is uncertain because it pertains to the selling board’s
Revlon duty to maximize shareholder value prior to the sale of the corporation, if the principal of
investment bank duty to adequately inform attaches equally to any board, then there are a myriad of circumstances in which an investment bank advisor may breach its duty to an acquiring board. For example, where an investment bank’s advisory or financing fees are contingent on a deal closing, it may have an interest in the deal closing regardless of whether the deal makes financial sense for the buyer. Likewise, if an investment bank has an interest in both sides of the transaction, such as where it may have an on-going financial relationship or existing business with the seller, it may be unable to give un-conflicted advice to an acquirer’s board.

In such circumstances, or simply where the bank itself was careless, the bank’s advice may not adequately inform the acquiring board. While such conduct would be a breach of the bank’s duty, and In re Rural Metro holds that the bank could be liable, this fact alone does not extinguish liability for a breach of the board’s duty of care. Thus, while seeking the advice of an investment bank as to whether a deal makes sense is evidence of an acquiring board’s attempt to make an informed business judgment, it does not establish that the board was actually informed. Because Delaware law requires the board’s reliance on outside experts to be reasonable, if the advice relied upon is flawed because the bank has breached its duty and it is unreasonable for the acquiring board to rely on such advice, buy-side directors who negligently base their business judgment on that flawed advice without dutifully informing themselves of the risk and other aspects of an M&A transaction have breached their own duty of care.

Regardless of whether an acquiring board relies on outside advisors however, in cases where it appears that integration may be difficult, an informed business judgment that a transaction is in the best interests of the corporation might require a close evaluation of a target’s PMI risk profile in due diligence. While such a duty may be logical, the notable absence of Delaware case law addressing the adequacy of buy-side due diligence is an indication that deference is given to directors who make at least some kind of effort to evaluate a transaction.

Oversight, the Duty of Care, and the Importance of the Merger Plan

While the board of directors has broad authority to manage the business and affairs of the corporation, the day-to-day operations of the corporation are delegated to the corporation’s officers. After this delegation, the board assumes an oversight role, and while the Dodd-Frank Act requires certain financial companies to have a designated risk-management committee, the board’s oversight role is usually delegated to the audit committee. While the board has a continuing obligation to uphold its fiduciary duties of care and loyalty, the board’s delegation of risk management to corporate officers means that, after an M&A transaction closes, the board’s role is to oversee the officer’s implementation of the merger plan. In this way, PMI and successful preservation of value are often in the hands of the corporate officers who are responsible for running the company day-to-day.

Much like the treatment of good faith board decisions under the business judgment rule, the board’s oversight is also given a great deal of deference. In Caremark, Chancellor Allen states that “…director liability for inattention is theoretically possible entail circumstances in which a loss eventuates from…unconsidered inaction,” but ultimately, the Court held that only a “…sustained or systemic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists…” can lead to director liability for failed oversight. In light of this “demanding test,” it is clear that any planning for PMI risk will remove the potential for director liability for failed oversight in the M&A context.
Because a merger plan is required to initiate the transaction and it seems that boards account and plan for PMI risk, the Caremark standard may be all but irrelevant for buy-side directors. Therefore, while there may be PMI risks that are “red flags” in regard to the level of risk posed by some aspect of integration, the board does not have a heightened duty to oversee the management of these risks, see In re Citigroup, even though good corporate governance would require the board to specifically address these risks in the merger plan.

**Conclusion**

In sum, the M&A decisions of buy-side directors will generally protected by the business judgment rule and their duty to oversee integration will be satisfied by good faith attempts to plan for and monitor PMI. Because risk is the counterpoint to creating value, there is a certain amount of risk in all strategic business decisions regardless of whether it is in the M&A context. Therefore, if the board’s role is to create value for the corporation and, ultimately, its shareholders, directors must be allowed to take risk. As explained in In re Citigroup, “ultimately, the discretion granted to directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses.” Thus, even though high-risk M&A can, and often does destroy value, the business judgment rule promotes value maximization by protecting the ability of directors to discern which transactions are in the best interests of the corporation. Regardless of how sound the board’s M&A judgment is however, optimal deal performance ultimately requires careful strategic evaluation and planning for PMI risks in order facilitate the officer’s implementation of the merger plan. Therefore, while the board’s duty to oversee may be somewhat of a formality, this role and the board’s preparation for a transaction are both key factors for accomplishing strategic objectives and in creating value for the corporation and its shareholders in M&A.