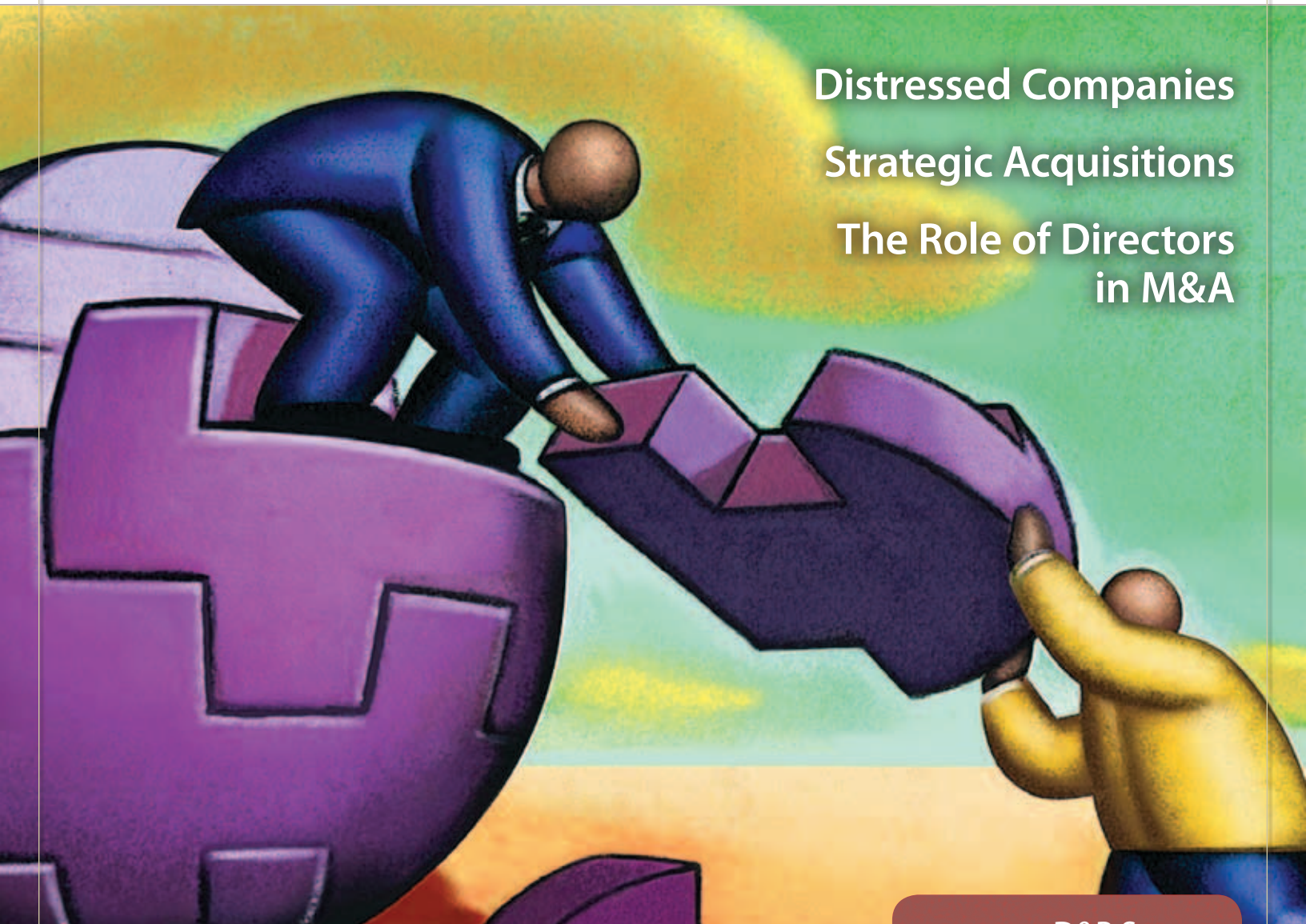


Boardroom Briefing

A publication of Directors & Boards magazine and GRID Media LLC

Mergers & Acquisitions 2009

Distressed Companies
Strategic Acquisitions
The Role of Directors
in M&A



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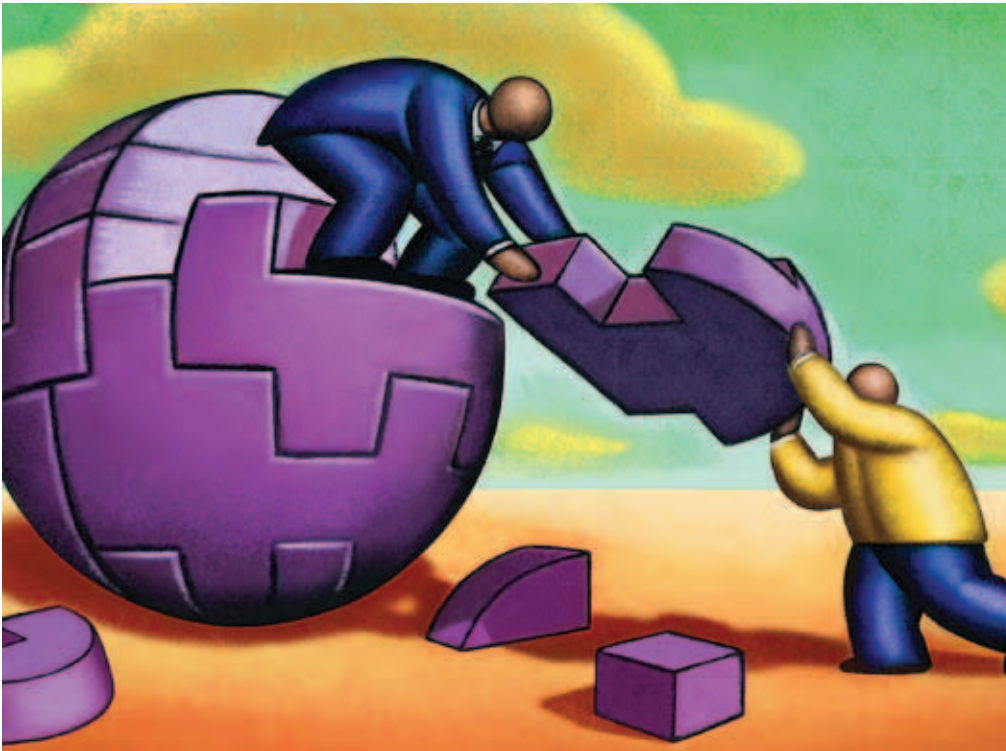
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The Many Sides of M&A 37
James Kristie

Keynote
 Thoughts on M&A in the Current Environment..... 38
Stanley W. Silverman

The Role of Directors in Acquisitions 40
Frederick D. Lipman

Transactions with Distressed Companies 42
Matthew M. McDonald and Jennifer J. Kolton

The Duties of Private Equity Directors of Distressed Companies..... 44
Richard F. Hahn, Jasmine Powers and Jessica Katz

The **Directors & Boards** Survey: Mergers & Acquisitions 2009 46
Sponsored by Drinker Biddle & Reath LLP

Strategic Acquisitions: Prepare to Buy 50
Joseph C. Lunkes

What's in store for the M & A Market in 2009? 52
Charles K. Oppenheimer

An M&A Executive Compensation Checklist 54
Don Delves and Rich Thoroe

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The Many Sides of M&A

By James Kristie

Yes, there are financial, legal, strategic, and tactical dimensions to getting a deal done—but never forget the human element. A tale from the Drake Hotel.



James Kristie

I'll never forget the story told by a big-name director who was keynoting an M&A conference back in the 1980s, when the

merger boom was running rampant. That director will go unnamed, as you'll soon see why (and also because the session was off the record). He was an oil patch fellow, but at the time was serving on the board of an apparel company that was being attacked by a raider. His job at the conference was to walk the audience through a case study of how the board handled this hostile assault.

He crunched the numbers in a reasonable fashion, and traced the steps that he and his fellow directors took in responding to this unwelcome would-be acquirer. But, in a moment of refreshing candor, he admitted that the primal reaction driving his behavior during the deal was outrage.

"They're trying to take away my suits!" he howled—to which we in the audience howled in laughter in return.

He wasn't talking about lawsuits, either. One of the bennies of being on this board was that the directors were suited up with several complimentary outfits each year. And *that* was just not right for any raider to mess with. So, if the directors had their druthers,

all they wished for was for the hostile party to just go away and leave them alone to enjoy their tailor-mades.

In the end, it was the end of the suits. The deal got done, the shareholders were well rewarded ... but, oh, what we heard in our keynoter's voice was the regret that lingered for the lost sartorial splendors.

There are many sides to an M&A transaction—financial, legal, strategic, tactical. And, as the above story testifies, there is a human element to every deal. You will find solid briefings on these dimensions of dealmaking in the following pages of this *Boardroom Briefing*, our fourth annual spotlight on M&A playbooks by leading practitioners.

I'm always taken with tales of how that human element compels—sometimes propels, sometimes repels—a transaction. My all-time favorite story came from an interview I did for **Directors & Boards** in 1984 with William Fishman, who over the course of 40 years as a serial acquirer had built up a multibillion-dollar diversified services company now known as Aramark Corp. (He died in 1991.) In no uncertain terms, he told me this: "The most important facet of any transaction is to establish a personal relationship between the seller and the buyer—not as companies, but as individuals. Until the seller has faith and believes the buyer, the transaction is a very cold and probably unsuccessful one." And then he proceeded to tell me this story:

"I well remember one transaction where I had worked the better part of three years on acquiring a company in Chicago that we desired very much, and I wasn't getting anywhere. The company was a competitor, so there was a natural amount of skepticism and hostility between us.

"But one day I just happened to take this fellow, whose business we were trying to acquire, to a restaurant in the Drake Hotel in Chicago. The waiter came up—I knew the waiter, I had been there often—and my guest looked at the waiter and, in the middle of his sentence, broke out in tears, weeping. I had not the slightest idea what he was weeping about. Well, it turned out that the waiter had waited on my guest's father back on the West Side of Chicago, and had always taken good care of his father—who had just recently died.

"This fellow had a tough, hard shell, but he wasn't hard inside. When I understood what he was crying about, that's when he and I began to relate. Those are the kinds of things that get into an acquisition that finance people don't always understand."

End of story. But the right place to start this *Boardroom Briefing*. Let the advisories that follow guide your thinking and your tactics ... and always keep that human element at top of mind.

James Kristie is editor and associate publisher of **Directors & Boards**, and can be reached at jkristie@directorsandboards.com.

Keynote: Thoughts on M&A in the Current Environment

By Stanley W. Silverman

To increase the likelihood that a deal can be completed, a company needs to differentiate itself from the pack.



Stanley W. Silverman

Recessions slow the pace of M&A activity due to a divergence of seller and buyer valuation expectations and a difficult

financing environment. Recessions are a natural part of economic cycles. They have occurred in the past, and will occur again in the future. Whether the divergence in valuation expectations during recessions can be sufficiently narrowed to close a deal depends on the motivations of both the buyer and seller.

How can a board and management team increase the likelihood that their company will successfully complete a transaction? For a buyer, this means having the confidence of investors and lenders that the company is well run, can successfully execute stated business strategies with the acquired company, and can deliver promised returns. For a seller, absent non-monetary considerations, it means obtaining the minimum acceptable price. A potential acquirer will pay more for a company if it feels the potential acquisition is well run and views it as a growth opportunity. The acquirer will pay less if it needs to fix the potential acquisition to significantly improve profitability.

Whether a deal can be financed during this or any other recession depends on whether the required

amount of equity and debt financing can be raised in an environment where both are in shorter supply than in times of economic expansion. During this recession, less debt financing is available, requiring that more equity be invested in deals, lowering leverage and potential returns for acquirers, which will drive lower valuations. This widens the gap between buyer and seller expectations. Sellers may choose to wait until valuations recover, and use this time to improve its operation so it can command a higher price when the M&A environment improves.

What the board can do

The role of the board in this process is to ensure the right CEO is in place, and develop with the CEO the right long-term strategies to differentiate the company from its competitors. The board also sets growth and profitability goals and expectations for the CEO, and monitors progress on the execution of the strategies and progress towards achieving the goals.

The board needs to establish a compensation program that rewards the CEO and senior management for achieving results with an acceptable level of risk to the company, and to ensure that an appropriate portion of bonuses are paid out over an appropriate time horizon. The board needs to avoid the situation which recently occurred in the financial industry where high risk strategies were pursued, short term financial results were strong, and large bonuses

paid. A few years later, these high risk strategies failed, placing some financial firms at risk of collapse.

The strategies to highlight a company through achieving great performance are the same regardless of the phase of the economic cycle. A company which has the right corporate culture, a well developed strategic direction, employs skilled leaders and managers, implements best operational practices, focuses on customers, pushes its manufacturing and product technology forward, has a strong balance sheet, does a great job managing working capital, has strong cash flow, focuses on achieving growth and generates attractive shareholder returns differentiates itself and will perform well in times of economic expansion as well as in times of recession. These attributes make a company a desirable investment and a strong acquirer, or an attractive acquisition candidate.

Tone and values

The tone at the top and the corporate culture that the CEO establishes is not only key to great financial performance, but company reputation as well. Tone establishes the values of the company, not only in terms of ethical behaviors, but all aspects of how the business is operated. The CEO sets the tone, and the board holds the CEO accountable for how well it's established and adopted throughout the company.

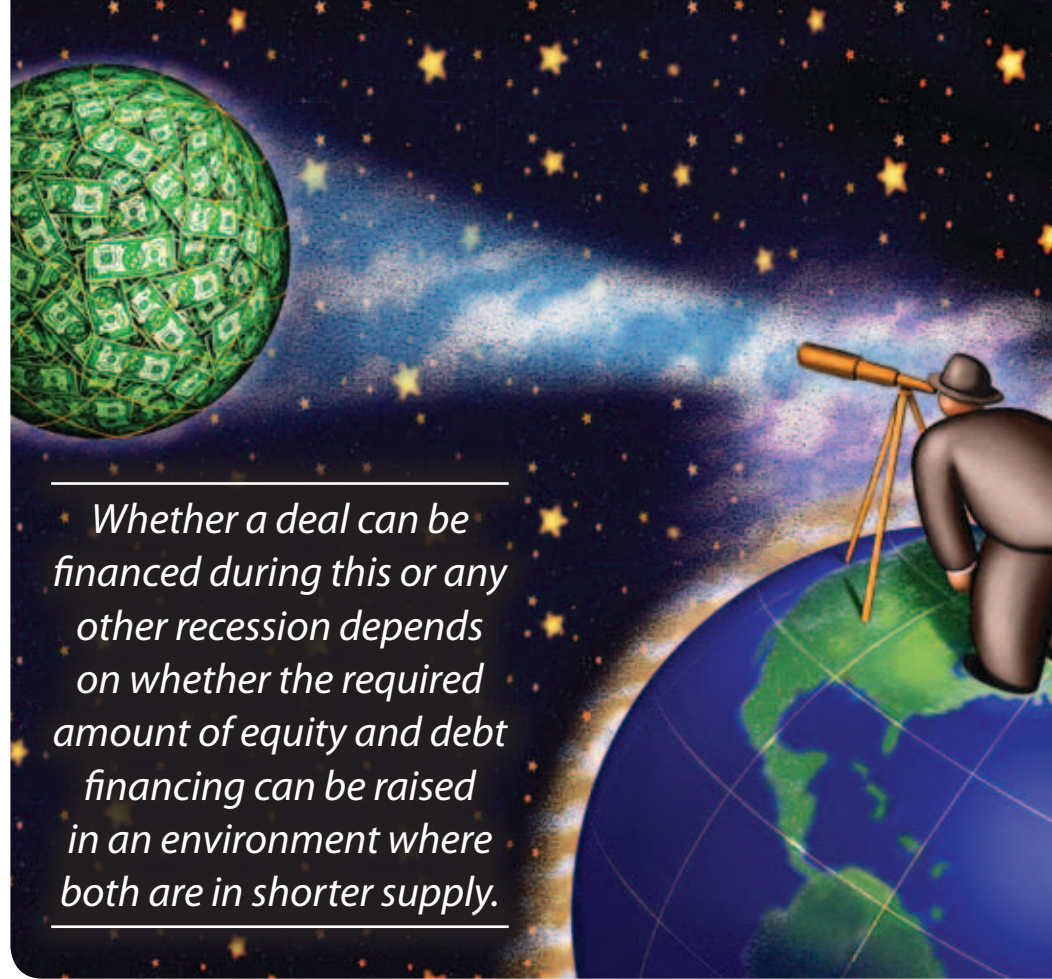
As a former CEO of a company with operations in 19 countries at 56 plants,

I wanted all employees to do the right thing—for example, maintaining the highest standards of safety and environmental compliance—even if it meant delaying a customer shipment or falling short of a production goal. I communicated our values as well as strategic direction and goals to employees at all levels of the company. Your employees will not know what your values are, and they can't help you implement the company's plans and achieve its goals, unless you communicate with them.

One of the most effective corporate cultural norms is a culture of continuous improvement, where all employees, both salary and hourly, feel a sense of ownership in the business and are empowered to improve the aspects of the operation over which they have control, either individually, or in teams with fellow employees. In my experience, a culture of continuous improvement generates significant savings for the company when done effectively on a sustainable basis. It's also a way of setting apart the company vis-à-vis competition and is required in order to build a sustainable competitive advantage. By empowering employees, you enrich their job satisfaction, which encourages them to continuously improve the business.

Deliver on your promises

Another cultural norm is always keeping commitments, and delivering what you say you are going to deliver. For a CEO, achieving established goals builds credibility with the board, investors and lenders, and increases the probability that he or she will attract outside capital and be supported on an investment in a new product initiative or acquisition. In the event the company becomes an acquisition candidate, buyers will pay more for a company where



Whether a deal can be financed during this or any other recession depends on whether the required amount of equity and debt financing can be raised in an environment where both are in shorter supply.

keeping commitments and achieving results are a cultural norm. The management team needs to keep their commitments to the CEO, to each other, and to their direct reports. This helps ensure that the company continues to move forward.

How do you get a deal done in a tough recessionary environment? If you are a buyer, you need to demonstrate to the providers of equity capital and debt financing that your company is one they should want to invest in by showing that you are financially and operationally sound, and that you are achieving the milestones of your strategic plan. If you are an acquisition candidate, you need to demonstrate the justification for your high EBITDA multiple expectations by showing that you are operationally sound, have a track record of profitability and growth, and have developed a sustainable competitive advantage. In both cases, whether a buyer or a seller, show that you have

a track record of meeting goals and delivering results. Even if you don't contemplate a transaction, these are sound principles for running a successful company.

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The Role of Directors in Acquisitions

By Frederick D. Lipman

Directors should do more than is minimally required under the business judgment rule.



Frederick D. Lipman

Directors are often requested to approve significant acquisition proposals, which typically are accompanied by rosy

management projections which more than justify the purchase price. Directors should be skeptical of acquisition proposals which promise significant cost savings, major synergies and considerable growth potential. A recent example is the purchase by a specialty retailer of another specialty retailer for approximately \$517 million in February 2006, with a press release claiming “significant growth potential,” enhanced “shareholder value,” and “cost synergies,” and the subsequent sale announced on June 2009 of that same company for approximately \$75 million, which was claimed to be a “significant strategic step forward” to enable the acquirer to focus on its core of business.

Director skepticism is more than justified by numerous academic and other studies which indicate that more than a majority of mergers and other acquisitions “fail,” depending upon your definition of failure. Moreover, some have argued that the rise in CEO and other executive compensation is directly linked to the size of the organization, thereby providing a management incentive for mergers and other acquisitions and may be partially motivated by CEO “hubris.”

In considering any significant acquisition proposal, directors must comply with the minimum legal duties under the business judgment rule and conscientious directors should do much more. Directors can satisfy their minimum legal requirements and nevertheless still approve an acquisition which is disastrous to shareholder value. Not unimportantly, directors who approve disastrous acquisitions are less likely to be invited to serve on other boards of directors.

For purposes of this article, we will assume that the management acquisition team does not have a demonstrated track record of having completed a large number of successful acquisitions, such as General Electric. We will also assume that the board is considering a significant merger or acquisition opportunity, with substantial cost to the company, that the proposed opportunity does not involve a change in control of the company itself, and that there is no conflict of interest because of the board or management involvement with the target.

At minimum

To comply with the minimum legal requirements of the business judgment rule in order to protect the directors from personal liability, the board should have several meetings to consider any significant acquisition proposal, spaced out over a reasonable period of time. The board should require complete presentations by management and outside experts on the proposed acquisition, including

a draft of the proposed acquisition agreement, and ask reasonable and hopefully probing questions. These standards result from such cases as *Smith v. Van Gorkom* and a host of other Delaware court cases which describe the procedures necessary to help establish a business judgment defense for directors.

Aside from establishing a business judgment defense, conscientious directors should understand best practices in effecting mergers and acquisitions. No company can grow without assuming some risk, notwithstanding the dismal success record of mergers and acquisitions. Therefore, the task of the conscientious director is to balance risk and reward. Although directors should not micromanage ordinary business decisions, directors may have a fiduciary duty to ask and, as a matter of best practice, should ask intelligent questions of management on any proposed merger or other acquisition. The extent of the inquiries should depend upon the experience and track record of the management team in making successful acquisitions and the potential impact of an unsuccessful acquisition.

Best practices

To ask incisive questions, directors must possess a full understanding of the reasons why mergers and acquisitions typically fail and an understanding of the best practices that management should be using. Directors should educate themselves on best practices by reading academic and other literature

which analyze the reasons mergers and other acquisitions fail. Directors without significant M&A experience should consider reading such books as *Deals From Hell: M&A Lessons That Rise Above the Ashes* which carefully examines 10 M&A “train wrecks,” as well as relevant academic studies which are freely available on the Internet. The education obtained from these books and studies will permit the board to ask the right questions of management. It also permits the board to determine if outside expertise is necessary to supplement management judgment and implementation tactics in connection with the proposed merger or acquisition.

Directors should be aware that the most successful deals are with targets in the same or a closely related industry. The worst deals typically occur in “hot” markets. Properly structured “earnouts” are generally associated with successful acquisitions.

Action items

Some of the major reasons cited in academic papers for the failure of mergers and other acquisitions are the following:

Management fails to perform adequate strategic due diligence.

Action Item. Strategic due diligence allows the buyer to question itself in a critical way as to what areas should be emphasized during its financial and operational due diligence investigation. The board should question whether outside expertise is needed by management.

Management fails to understand the customer relationships of the target employees, with the result that significant revenues are lost when key employees leave the target and take customers with them.



Directors must possess a full understanding of the reasons why mergers and acquisitions typically fail and an understanding of the best practices that management should be using.

Action Item. The Board should question how management determined who the key employees of the target were for purposes of customer retention and request information as to contractual obligations (e.g. non-compete or non-solicitation of customer provisions) which are being imposed upon these employees as a result of the acquisition.

The failure to perform adequate financial and operational due diligence on the target, including problems in the base business of the target, which ultimately result in failed projections of increase revenues and synergies.

Action Item. The Board should question whether outside expertise is needed and ask questions as to the assumptions of increased revenues, cost savings and other synergies.

The failure to properly integrate cultures of the target with the acquirer.

Action Item. Studies indicate that cultural integration must begin well before closing the acquisition and the board should understand management’s proposal to ameliorate this risk. In general, the best practice is to have the same team members who provided due diligence for the acquisition follow-through in the post-acquisition period.

The key to great M&A investing is to learn from the mistakes of others. It is the directors’ job to help management focus on the key reasons of M&A failures and to apply the lessons learned to each proposed significant acquisition.

Frederick D. Lipman is a partner at Blank Rome LLP and author of *Corporate Governance Best Practices* (John Wiley & Sons, Inc., 2006) and *Valuing Your Business* (John Wiley & Sons, Inc. 2005).

Transactions with Distressed Companies

By Matthew M. McDonald and Jennifer J. Kolton

Key Questions for Directors



Matthew M. McDonald



Jennifer J. Kolton

As banks and other traditional sources of capital find their balance sheets reflecting more and more underperforming assets, lending standards continue to tighten, leading to the well-publicized lack of commercial credit. Alternative sources of capital, such as private equity financings or the public securities markets, are also out of reach for many companies. The unprecedented government spending packages sponsored by the Bush and Obama administrations have made funds available in certain key industries and to companies deemed “too big to fail,” but many businesses are either unable to take advantage of the government programs or unwilling to accept the strings attached to the funds being offered. As a result, an increasing number of companies find themselves facing a significant liquidity crisis, with many seeking protection in bankruptcy proceedings. The Administrative Office of the U.S. Courts reports that over 43,000 businesses filed for bankruptcy during 2008, while the American Bankruptcy Institute reports over 14,000 bankruptcy filings by businesses during the first quarter

of 2009, an increase of approximately 30% on an annualized basis.

Although the current economic climate poses challenges to distressed businesses, it may also provide opportunities for more economically sound companies to acquire key assets or lines of business at bargain prices. But are these deals too good to be true?

Suppose that you are approached by your management team with an opportunity to acquire the assets of a competitor at an attractive price. Management advises that the deal will need to close quickly, as the competitor does not anticipate having sufficient liquidity to satisfy its outstanding obligations. If the asset sale does not close soon, the competitor will have no choice but to file for bankruptcy and seek to sell its assets off under the supervision of the bankruptcy court.

As a director evaluating this situation, one of the most important decisions to be made is whether your company is better off purchasing the assets offered outside of bankruptcy or allowing the target company to file before seeking to acquire the assets. Unfortunately, there is no “one-size-fits-all” answer, but here are some key questions to ask when contemplating a transaction with a distressed company:

Have you considered the costs beyond the purchase price?

Bankruptcy can be time-consuming and expensive, both in terms of management attention and outside counsel fees. For these reasons, many directors assume

that a private sale is preferable to buying through bankruptcy because it involves lower transaction costs and requires less time to close. Further, a potential buyer in a bankruptcy context may spend time and money negotiating with a target, just to find that it is the “stalking horse” in a bankruptcy auction and may be outbid. A buyer in bankruptcy will also be at the mercy of the schedule of the bankruptcy court, which can be quite different from the timeframes involved in a typical corporate transaction. Once the transaction costs of a bankruptcy proceeding are factored in, the bargain price a purchaser thought it was getting may not be so attractive.

Is it a deal or a steal?

If the board follows the advice of management and negotiates a purchase of key assets from a distressed competitor outside of bankruptcy, there are other issues to consider. While the purchaser can, and should, use the negotiating leverage provided by the target’s financial distress, the deal must provide reasonable value for the assets being acquired.

A buyer that engages in a purchase of assets with a distressed company outside of bankruptcy risks that creditors in a subsequent bankruptcy will claim that the amount paid for the assets was too low. If the target company’s creditors successfully argue that the target was insolvent at the time of the acquisition (or was rendered insolvent by the acquisition), and that the price paid was less than the “reasonably equivalent value” of the assets acquired, the court may find that a fraudulent conveyance

occurred, regardless of whether there was any intent on behalf of the parties to defraud creditors. There is no single definition of “reasonably equivalent value,” but courts will often look to the fair market value of the assets acquired, with adjustments deemed appropriate given the circumstances surrounding the transaction. If a claim of fraudulent conveyance succeeds, the bankruptcy trustee can seek to have the transferred assets (or their fair value) returned to the bankruptcy estate to be distributed to creditors. Even if the fraudulent conveyance claim fails, defending against such a claim could result in significant costs that may outweigh any savings recognized by proceeding outside of bankruptcy. Purchasing assets through bankruptcy does not eliminate the possibility of a fraudulent conveyance claim, but should substantially minimize the risk that a claim will be brought or succeed.

Who are the target’s creditors?

When dealing with a distressed company, a potential purchaser must understand the target’s creditor base, including the scope and nature of the indebtedness involved. If the company has debt secured by its assets, it will be impossible to acquire those assets free and clear of the lien outside of bankruptcy without either paying the secured debt in full or making another arrangement with the secured creditor. On the other hand, in a bankruptcy, the bankruptcy court’s order will generally allow a buyer to take the target’s assets free and clear of most liens, including the liens of secured creditors.

Even if a company does not have any secured creditors, a potential purchaser should also consider the trade and other unsecured creditors of the target company. Trade creditors often consist of suppliers or service providers who are critical to the operation of the target’s business.

If the value of the acquired assets depends on the continued goodwill of these unsecured creditors, the purchaser must carefully consider how those creditors will be treated in the transaction. If the unsecured creditor base is disorganized and dispersed, the purchaser may have more success in striking individual deals that maintain good relations with those creditors after the closing. If, instead, the creditor base is tightly-knit and organized, the purchaser will have to deal with the creditors as a group, which may prevent the purchaser from striking a deal on as favorable terms as it would like.

There is always a risk that the target’s creditors will file an involuntary bankruptcy petition, forcing the target company into bankruptcy.

Finally, there is always a risk that the target’s creditors will file an involuntary bankruptcy petition, forcing the target company into bankruptcy. Understanding the company’s creditor base in advance will help directors better assess which creditors have the most to gain from such an action.

Are you protected after the purchase?

A final consideration when dealing with a distressed company is the potential for successor liability after the purchase and what, if any, indemnification will be available to the buyer. Although the buyer should seek to structure the transaction to limit the liabilities assumed by it, proceeding outside of bankruptcy exposes a buyer to potential

claims from frustrated creditors—primarily that by purchasing the assets of the distressed company, the buyer also took on the liabilities of that company. Contractual indemnification may provide little comfort in these situations, as the distressed company may be in no position to honor any indemnification obligations under the purchase agreement, particularly if the company has gone into bankruptcy following the purchase.

Acquisitions through bankruptcy may allow the buyer to more effectively limit the liabilities it assumes in the transaction, but won’t generally offer anything more in the way of indemnification. Purchase transactions in bankruptcy typically involve limited representations and warranties from the seller, often focusing on fundamental matters such as organization and title to assets, and otherwise take the form of “as is, where is” sales with limited post-closing indemnification. Regardless of whether a transaction with a distressed company takes place inside or outside of bankruptcy, a wise buyer will seek a post-closing escrow or purchase price holdback to secure any indemnification obligations of the seller. As a practical matter, the funds escrowed or held back will likely be the only funds available to address damages suffered due to breaches of the seller’s representations and warranties.

Evaluating a transaction with a distressed company involves a number of practical and legal considerations. Directors must analyze these considerations to avoid getting more than they bargained for. Nonetheless, through careful analysis and negotiation, economically sound companies may find good opportunities to acquire key assets or lines of business at bargain prices.

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The Duties of Private Equity Directors of Distressed Companies

By Richard F. Hahn, Jasmine Powers and Jessica Katz

Avoiding an Intrinsic Fairness Review



Richard F. Hahn



Jasmine Powers



Jessica Katz

When times are good, the goal of private equity professionals serving as directors of portfolio companies is relatively straightforward—maximization of value for the corporation’s shareholders. Moreover, the interests of the two constituencies that the private equity professional serves—his private equity firm employer and the portfolio company’s shareholders—are typically aligned as the private equity

firm is usually the portfolio company’s largest shareholder.

When a portfolio company becomes insolvent, however, the legal standard by which the actions of a private equity professional serving on its board are judged may be materially more demanding. Private equity professionals serving as directors of portfolio companies during the current economic downturn should

therefore understand the duties they owe to the stakeholders in the corporations they serve and the impact of the corporation’s financial condition on these obligations.

Directors typically owe the corporation and its shareholders a duty of care and a duty of loyalty. The duty of care requires that directors exercise the degree of care that an ordinary and prudent person would use in similar circumstances. The duty of loyalty requires that directors act in good faith in the best interests of the corporation and its shareholders and that they not engage in self-dealing.

Challenges to directors’ decisions are generally difficult to sustain because of the protection afforded to directors by the “business judgment rule.” So long as directors are not “interested” in the matter before them, they benefit from the presumption that they acted on an informed basis, in good faith and in the honest belief that their decision was in the best interest of the corporation.

But the business judgment rule does not apply where it can be shown that a majority of the directors were either interested in a transaction—by, for example, standing on both sides of the transaction or expecting to derive a personal and substantial financial benefit therefrom—or lacked independence such that the decision was not based on the merits of the transaction. In these cases, the burden of proof shifts to the directors to show the “intrinsic fairness” of the transaction—that the actions of

the board were both procedurally and substantively fair. A court’s determination as to whether to apply the intrinsic fairness test, given the higher standard to which this test subjects a director’s conduct, may dictate the outcome of a challenge to a board’s decision and, at the very least, whether the challenge will survive a summary judgment motion.

What is intrinsic fairness?

Courts have held that there are two aspects to the intrinsic fairness test: fair dealing and fair price. Fair dealing focuses on the actual conduct of the directors in effecting the transaction, including how the transaction was initiated, structured and negotiated. Fair price relates to the economic and financial terms of the transaction, including a review of the value that an otherwise arm’s-length transaction would provide. Courts focus on both elements of the test as part of an integrated analysis of all aspects of the transaction.

When a corporation is solvent, the directors only owe fiduciary duties to the corporation and its shareholders. Generally, creditors are entitled to only those contractual rights set forth in their financing or other agreements. However, once a corporation becomes insolvent, the directors’ fiduciary duties run to an expanded constituency that encompasses not only the corporation and its shareholders but also the corporation’s creditors. The assumption underlying this expansion is that once a corporation is insolvent, the residual value of the corporation may belong



However, once a corporation becomes insolvent, the directors' fiduciary duties run to an expanded constituency that encompasses not only the corporation and its shareholders but also the corporation's creditors.

to the corporation's creditors and not its shareholders. This shift can have a significant impact on the application of the intrinsic fairness test, particularly with respect to closely held corporations such as portfolio companies.

When the constituencies to which a director owes duties is expanded, the range of transactions in which a director may be "interested" may also grow. For example, a private equity sponsor employee who sits on the board of a solvent portfolio company generally owes fiduciary duties to the sponsor, as the controlling shareholder of the subsidiary, and may therefore approve transactions that are beneficial to the sponsor without concern that his decisions will be reviewed under the intrinsic fairness test, assuming that minority shareholders are treated fairly. However, once the portfolio company is insolvent, the director also owes duties to the creditors of the portfolio company, and the director's relationship with the sponsor may render him interested with respect to any transaction benefiting the private equity sponsor even in its capacity as a shareholder.

In fact, the Bankruptcy Court for the District of Delaware recently found that a Chapter 7 trustee had sufficiently alleged a breach of the duty of loyalty against a private equity sponsor, its counsel and the portfolio company's directors to survive a

motion to dismiss. In *In re The Brown Schools, et al.*, the trustee successfully argued that a series of otherwise unsurprising restructuring transactions that preceded the portfolio company's bankruptcy should be evaluated under the intrinsic fairness test because the defendants had engaged in self-dealing.

The alleged self-dealing included the payment of certain advisory fees to the private equity sponsor and a grant of junior liens to secure loans the private equity sponsor previously made to the portfolio company. In so holding, the Bankruptcy Court turned what appeared to be a relatively standard duty of care case (reviewed under the deferential business judgment standard) into a duty of loyalty case (reviewed under the more rigorous intrinsic fairness standard). It is important to note that in tendering the *Brown Schools* decision, the Bankruptcy Court was required to accept the trustee's factual allegations as true and was precluded from considering defenses that the defendants might assert. However, the decision is nonetheless cause for caution.

What should directors do?

Given that an increasing number of corporations are or may be facing insolvency, the primary goal for the directors of any corporation should be the preservation of the protection

afforded by the business judgment rule. To achieve this, a private equity sponsor should consider ensuring that at least two independent and disinterested directors sit on its portfolio company's board of directors and may even wish to constitute a special committee of disinterested directors to deliberate on matters that raise conflict issues for other directors. Where disinterested directors serve on the portfolio company's board, it is essential that these directors are fully informed concerning the transactions before the board and the private equity sponsor's interests in the transactions and participate meaningfully in the decision-making process. Finally, these actions should be reflected in the records of the board's deliberations.

If the board does not have independent directors, the sponsor and its portfolio company should assume that board decisions impacting the sponsor will be reviewed under the more demanding intrinsic fairness test and consider how best to structure board deliberations in that light. How frequently and when should the board meet? What advisors should be retained? What input should be provided by these advisors? What records should be kept of the board's deliberations?

Private equity professionals serving as directors of portfolio companies will want to be mindful that the current downturn may create complexities in fulfilling their legal obligations that are not present in a more favorable economic environment. Generally, the structure of board deliberations should be carefully managed to avert unanticipated challenges to the process and the result.

Richard F. Hahn and Jasmine Powers are partners and Jessica Katz is an associate in the New York office of Debevoise & Plimpton LLP. A version of this article originally appeared in the Winter issue of the Debevoise & Plimpton Private Equity Report.

The Directors & Boards Survey: Mergers & Acquisitions 2009

Sponsored by **DrinkerBiddle**

Methodology

This **Directors & Boards** survey was conducted in June 2009 via the web, with an email invitation to participate. The invitation was emailed to the recipients of **Directors & Boards'** monthly e-Briefing. A total of 372 usable surveys were completed.

About the respondents

(Multiple responses allowed)

A director of a publicly held company	34.6%
A director of a privately held company	44.9%
A director of a non-profit entity	40.5%
A senior level executive (CEO, CFO, CxO) of a publicly held company	6.5%
A senior level executive (CEO, CFO, CxO) of a privately held company	25.9%
Institutional shareholder	5.9%
Other shareholder	18.4%
Academic	10.3%
Auditor, consultant, board advisor	14.1%
Attorney	14.1%
Investor relations professional/officer	3.2%
Other	7.6%

(Other responses include: Head of executive compensation, retired public company director, retired public company CEO.)

Revenues

(For the primary company of the respondent)

Average revenues:	\$2.056 billion
Less than \$250 million	50.5%
\$251 million-\$500 million	8.7%
\$501 million to \$999 million	9.2%
\$1 billion to \$10 billion	25.5%
More than \$10 billion	6.0%

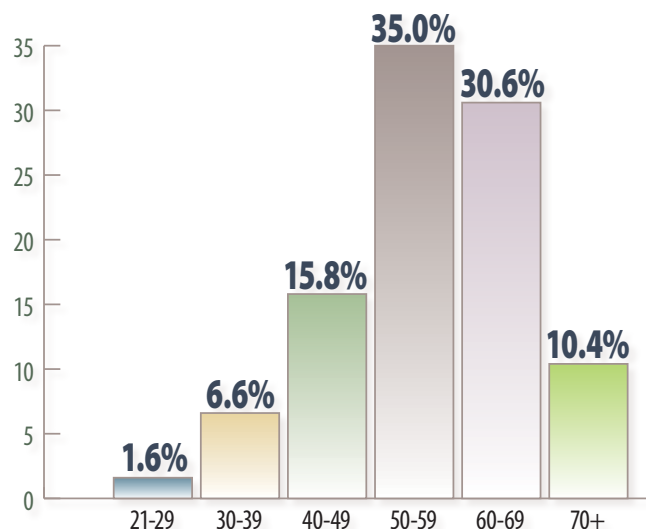
Board Service

(Average number of boards respondents serve)

Public	1.25
Private	1.75
Charitable	1.58

Respondents' Age

Average Age: 56.7



M&A and the Economy

In your opinion, how will economic conditions look by the end of this year?

The economy will continue to be in recession	23.0%
The economic recession will bottom out, but the economy will be flat for 2010	49.4%
The economy will begin to rebound by the end of the year, and 2010 will be a year of economic growth.	25.9%
Other	1.7%

How will the economy affect M&A activity for the remainder of 2009 and into 2010?

(Multiple responses allowed)

It will reduce M&A activity generally	39.4%
It will increase M&A activity generally	35.4%
It will reduce private equity participation in M&A	31.4%
It will benefit strategic and cash/stock M&A activity	46.9%
It will have little or no effect on M&A activity	4.6%
Other	0.6%

> ADDING VALUE TO M&A

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For more information, visit us at www.drinkerbiddle.com.

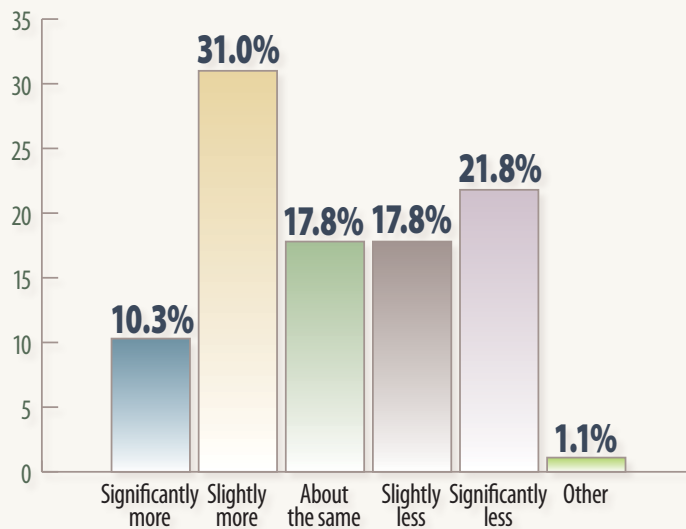
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Compared to 2008, please predict how M&A transactions will look in your primary company's industry by the end of 2009?



Your Company's Recent M&A Experience

Has your primary company engaged in M&A activity in the past year?

(Multiple responses allowed)

Yes, we purchased a company(ies) or business unit(s)	34.7%
Yes, we sold a company(ies) or business unit(s)	14.0%
Yes, but we did not make a purchase or sale	18.7%
No	40.0%

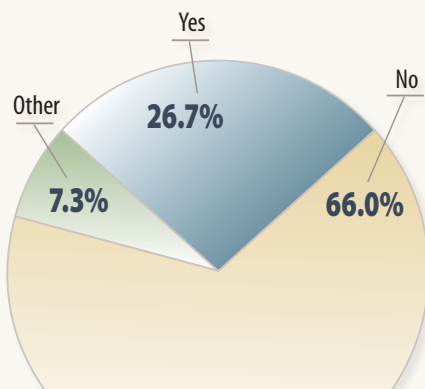
If yes, what was the approximate aggregate deal value of these purchases/sales?
\$221,526,565

Which of the following factors do you think will influence your company's M&A strategy throughout 2009?

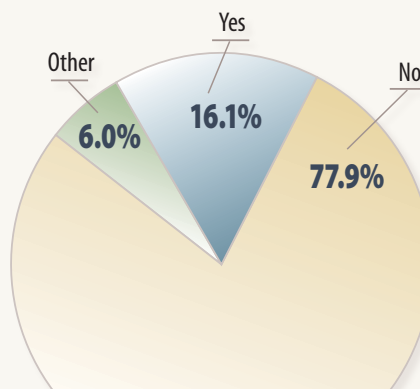
(Multiple responses allowed)

Availability of attractive acquisition opportunities	62.8%
Availability of capital	42.8%
The state of the economy	38.6%
Current and predicted financial results	29.7%
Add-on acquisitions	30.3%
Credit availability	29.7%
Global growth	23.4%
Moving into/out of new lines of business	22.8%
Regional growth	18.6%
Interest rates	11.7%
Other	5.5%

Does your primary company plan to purchase a company or line of business before the end of 2009?



Does your primary company plan to sell a company or line of business before the end of 2009?



Is the "supply" of acquisition targets in your primary company's sector currently...

Greater than it was last year	37.0%
Less than it was last year	19.9%
About the same as it was last year	43.2%

In your opinion, what will the "hottest" regions be for M&A activity this year?

(Multiple responses allowed)

North America	58.2%
China	19.9%
India	13.7%
Asia	17.1%
Europe	20.5%
Middle East	5.5%
South America	12.3%
Africa	5.5%
Not Applicable	12.3%
Other	0.7%

In thinking about 2009 as a whole, which one of the following sectors do you think will prove to be the most active in terms of M&A?

Financial services	25.5%
Technology	15.4%
Industrial	8.7%
Aerospace	0.7%
Agriculture	0.7%
Biotechnology	12.1%
Media	4.7%
Energy	10.1%
Consumer Products	4.7%
Healthcare	10.7%
Other	6.7%

In your primary company's sector over the past year, what has been the average acquisition multiple of cashflow/EBITDA paid by buyers?

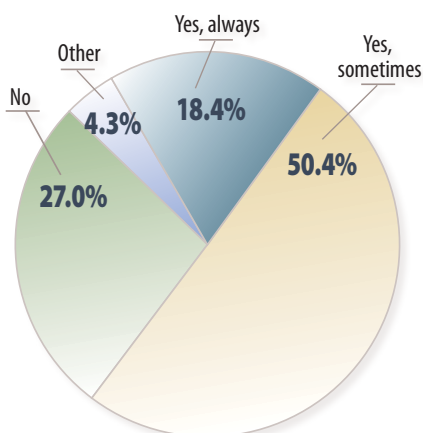
Less than 6 x	22.8%
6-7 x	20.7%
8-9 x	10.3%
10-11 x	5.5%
12-13 x	2.8%
14-15x	0.0%
Greater than 16x	2.1%
No M&A activity/Not known	32.4%
Other (please specify)	3.4%

In your opinion, and compared to prior years, was the cashflow multiple paid in your primary company's sector

Very high	4.2%
Somewhat high	14.1%
Average	24.6%
Somewhat low	22.5%
Very low	8.5%
Not applicable	23.9%
Other	2.1%

Mergers & Acquisitions and the Board

Does your board engage its own independent M&A advisors when contemplating purchases or sales?



What external resources do you use to determine the validity of information presented during an M&A transaction?

(Multiple responses allowed)

Management's M&A firm	45.7%
Board's M&A firm	24.6%
Management's law firm	44.2%
Board's law firm	23.9%
Management's accounting firm	38.4%
Board's accounting firm	20.3%
Independent consultants from related industries	47.1%
Other	5.8%

In the past year, has your board voted down or materially changed a contemplated acquisition or sale?

Yes	22.9%
No	57.1%
Not applicable	16.4%
Other	3.6%

If yes, why?

(Multiple responses allowed)

Not applicable	26.0%
Shareholder resistance	6.0%
The health and/or prospects of the acquired company were misrepresented	20.0%
FCPA issues	2.0%
Material disclosures were omitted	14.0%
Misalignment with our strategy	14.0%
Economic conditions	38.0%
Business conditions	34.0%
Other	10.0%

Are you seeing M&A opportunities emerging as a result of economic conditions? If so, what kinds of opportunities are presenting themselves?

Selected Comments

Yes, financial institutions are short of capital and need help.

Energy sector...especially "solar"...strategies that is aiming at sectors that do not rely on "subsidies" and rely less on Silicon.

Weakened companies that have no significant access to capital and who don't want to use their stock as currency due to the material dilution impact that would result. The valuations are attractive for strategic acquisitions.

The stronger corporates from emerging markets will find an opportunity in acquiring corporates who have catered well to the economies now in trouble for acquiring competencies that can make them global organizations. They will gain in terms of valuation, quick pay back and value creation in their domestic turf which will help them build a faster growth in domestic market while bringing advantages of scale in the context of global market. A few large players may also go for backward integration by acquiring capabilities through cross border deals. PE funds may find new opportunities in these deals for hiking up a higher and more diversified return on their capital. Some of these deals may push boundaries of regulations and trade treaties in bilateral or multilateral contexts, calling for reforms and collaboration between market regulators across the globe. Weakness in the USD and Euro may also trigger capital flows chasing M&A opportunities transatlantic as well as transpacific.

Struggling companies are keeping options open, especially if they are uncertain about their ability to refinance existing debt.

Much smaller companies which in the past had waited for the most opportune moment to consider a sale have had to come into the market anyway in order to survive.

If you have the capital, you can pick up some very good companies at very reasonable prices.

Strategic Acquisitions: Prepare to Buy

By Joseph C. Lunkes

A key component of an effective corporate development strategy is strategic acquisitions.



Joseph C. Lunkes

Corporate boards must not lose sight of one of their primary responsibilities—to focus management on strategy development and long-term business performance. This is especially true in today's market when the prevailing focus of management may be to impose constraints in response to recessionary conditions. A key component of an effective corporate development strategy is strategic acquisitions.

Like the economy, merger and acquisition markets move in cyclical patterns. Beyond the obvious cycles of reduced deal activity and valuations, some cyclical trends are now favoring strategic acquirers. Boards of directors would be wise to encourage their management teams to prepare for and exploit these opportunities.

The M&A cycle

Private equity groups' prominence in the acquisition market has faded and this trend will continue for several years. Syndicated credit markets tapped to fund these acquisitions have dried up and will remain so for the next few years. The stock market decline has forced institutional purveyors of private equity capital to reassess their assets allocations and portfolio liquidity, resulting in diminished capital allocations. Fund performances will catch up with

public market trends and the results will not be attractive, resulting in the contraction of private equity firms.

The M&A market cycle will also swing to smaller deals. With both stock and M&A market valuations down, deals involving larger corporations are more likely driven by restructuring sellers versus acquirers pursuing corporate development. In addition to restructuring, activity in the middle market will also be driven by the life cycle needs of aging entrepreneurs and private equity limited partnerships, both of whom will face increasing pressure to create a more liquid equity investment.

In recent years, speed to close and value dominated the decision-making criteria for evaluating potential suitors. These were the hallmarks of private equity. Today, strength of financing and strategic fit are key criteria sellers and their advisors use to assess suitors and assign a probability to close. With strong balance sheets and firm banking relationships, focused corporate acquirers should exploit this advantage.

Conventional wisdom suggests that valuations are down and sellers will not be motivated until there is an alignment of market values with their intrinsic value. This is typically true at the onset of a cyclical downturn but as noted above, the pressure of weakened financial performance or non-economic life cycle considerations begin to mount. Credit market conditions will compel weakened firms to seek suitors at attractive acquisition prices. As the duration of the cycle becomes more apparent, life cycle

sellers will be influenced to consider more creative ways of structuring deals to bridge the gap between market and intrinsic valuations.

It sounds trite to say it is a buyer's market, but history supports this assertion. The vintage years of private equity investment performance are those just after the recessionary periods of the mid 1990s and early 2000s. Honest private equity professionals will confide that this timing, and the market impact on cyclical valuations and deal structure, had a significant impact on their investment successes. In the context of current market outlook, directors would be wise to push management to prepare for and consider acquisitions now.

Acquisition strategy

Acquisition activity should be driven by corporate strategy. Some of the most successful strategic acquirers have achieved superior performance through a series of small, incremental acquisitions. Acquisition targets must benefit a business unit's performance and competitive position. Targets should expand a business' intellectual properties, increase product offering or customer reach, reduce costs, or improve asset utilization.

Acquisition strategy should involve different points of view with balanced organizational decision making, rather than a top-down activity. Successful acquirers have a common trait of empowering unit managers to seek out and sponsor acquisitions. Line managers are responsible for

determining the strategic direction of their business unit. These managers should be encouraged to seek out opportunities and advocate for deals that could augment organic growth. Corporate officers are most effective when they provide encouragement, counsel, and tactical support of line managers' initiatives.

The goal of every acquisition should be to generate a positive contribution to the creation of shareholder value. A key role of senior management is to evaluate the potential of strategic acquisitions to increase the value of the company. While legal and market forces require management and their advisors to focus on value at the time of close, careful consideration should be given by managers to stress testing against multiple scenarios. Value is created in the future and stress testing will identify the key variables that will have the biggest impact on the creation or dissipation of value.

Post-deal integration is key to creating value. Having identified the key variables that will drive value creation, a plan to attain these goals must be established. Responsibilities must be assigned and accountability identified. Additionally, board members must insist that they be periodically apprised on a post-closing basis of line and corporate management's progress toward the attainment of these goals.

Growth via acquisition should be a premeditated endeavor. Internal and external resources must be devoted and aligned in anticipation and support of this effort. The last year has been witness to unprecedented contraction in deal activity. Investment banking, accounting and tax due diligence, legal, insurance, and human resource service providers have seen one of their more sustaining client constituents, private

equity groups, run off the field. Boards and management should avail themselves to these resources and tap into the deal industry's network of relationships and deal flow.

Finally, many industries are now competing on a global basis. Directors should encourage management to look abroad; supply chains now stretch around the globe as the English language and Western business

A second consideration involving this transaction was the regulatory approval requirements of the Committee on Foreign Investment in the United States (CFIUS). CFIUS is an inter-agency committee that reviews proposed acquisitions of domestic firms by foreign entities. Particular emphasis is placed on defense and strategic industries. As IAI emerged as the lead bidder, the seller's deal team was expanded to include Washington-based

With strong balance sheets and firm banking relationships, focused corporate acquirers should exploit this advantage.

practices have been adopted by the international business community. The support networks of advisory firms have evolved beyond historic multinational clients and are now enabling cross-board middle market deal activity.

Case study

A recent Houlihan Smith & Co. transaction highlights the opportunities awaiting corporations that have implemented these practices. Houlihan Smith & Co. represented the owners of Analytical Methods, Inc., a lower middle market company providing specialized aerospace software and consulting services. The acquirer was a division of multinational Israel Aerospace Industries, Ltd. The authority IAI's divisional managers possessed to seek out and investigate acquisition candidates was key to making this deal possible. The deal was too small to ever attract the attention of corporate management; however, corporate practices encouraged unit managers to find and advocate deals that would grow their units. Pre-established corporate development guidelines enabled efficient review, analysis, and approval by overseas corporate management.

legal counsel experienced in filing these voluntary notices. This effort was augmented by the buyer's pre-existing advisory team retained to provide support for this approval process.

A key responsibility of directors and the boards they comprise is to keep the corporation's focus on long-term strategy and corporate development efforts. Strategic acquisitions are a key component to achieving these goals. Over the next year or two, market conditions will favor strategic acquirers. Maintaining a prepared management team and updated practices will enhance a corporation's ability to successfully identify and respond to opportunities the market will present.

Joseph C. Lunkes, CPA is a senior managing director at Houlihan Smith & Company, a specialized investment banking firm that provides financial advisory and financing services to public and private businesses. Founded in 1996, Houlihan is recognized as a leading provider of financial opinions, financing, merger and acquisition advisory, and other corporate advisory services. Lunkes graduated with honors from Loyola University and earned his MBA from Northwestern University's J.L. Kellogg Graduate School of Management. He may be contacted at jlunkes@houlihansmith.com or (312) 499-5938.

What's in store for the M&A Market in 2009?

By Charles K. Oppenheimer

Deals are down, multiples have hit bottom . . . but credit is still tight.



Charles K. Oppenheimer

Last year in these pages I noted that M&A activity was dropping and credit was tightening. Hopefully we have hit the bottom,

although that doesn't mean a return to historic levels anytime soon. It took a little longer than expected for the multiples to drop, and no question deals are down. In spite of some who say credit is softening, I don't see many signs of that.

What is the market for this year? Some deals will continue to get done but at lower multiples than last year. Financing for M & A transactions remains very hard to get and I don't see it coming back very fast.

Private Equity: Private equity still has billions of dollars to put to work and transactions continue to be completed. Estimated dry powder is in the range of \$400 billion. Fund raising continues but at a slower rate. "PitchBook" reports that \$296 billion was raised in 2008 while only \$81 billion has been raised the first half of 2009. Private equity transactions are still getting done but it is much harder. Almost all transactions closed have an owner carryback component. The majority of the private equity community is focusing on add-ons for existing portfolio companies versus new platforms.

Many private equity groups have focused on working with their

portfolio companies, helping them cut costs, find new customers, and get more sales from existing customers. Some private equity groups have scaled back their staff, including Sun Capital Partners and others.

Corporate Strategic Acquisitions:

Corporate acquisitions have fared better than private equity acquisitions. Many corporations see this downturn as an opportunity to acquire market share, expand product lines, and gain talent at reduced prices. Healthy corporations have cash and can also get financing for transactions. Strategic acquirers can look at a transaction differently than private equity that needs to reach certain returns.

Foreign Buyers: Foreign buyers seem to remain skeptical of US investments. If you track them over the years in good times as well as bad, many come in strong but end up leaving. For example, Marks & Spencer Group plc in London acquired several companies in the US but sold their last US holding, Kings Supermarkets, in 2006.

Financing: Financing is probably the most difficult issue with all transactions today. What most borrowers will find with lenders is that they are not lending and if they do you won't like the covenants. For a private equity group a transaction has to be very attractive for a lender to consider financing, and even then the lender will expect the private equity group to put in anywhere from 40% to 60% of the price. The private equity groups will also expect the selling owner(s) to carry back some paper.

For some groups the requirements are too rich, so they are concentrating on add-on acquisitions that are easier to do because of existing equity in the portfolio company.

The corporate side may afford lenders more protection against losses as corporations may have more in the way of assets and cash flow to cover the debt should a loan go bad.

Either way, bank covenants will be more stringent and banks will be paying more attention to their borrowers. Banks are very cautious about lending and many have scaled back their loan departments. Banks are most likely to focus on the crème la de crème borrowers with a good track record.

Smaller Banks: Some smaller and regional banks that have not been hurt as badly; some have been willing to do some financing for smaller acquisitions.

Non-Bank Sector: The non-bank sectors have become an increasing source of financing for acquisitions. According to "PitchBook," of the top 15 lenders in private equity (by number of financings provided), ten are non-banks or non-bank subsidiaries of banks. Will these sources be able to keep the cash flowing inward so they can lend? CIT became a bank holding company so it could tap into TARP money from the government (as have a couple of others).

Lending: Ultimately, banks need to lend money and the flow will



Many corporations see this downturn as an opportunity to acquire market share, expand product lines, and gain talent at reduced prices.

begin again but on a much more conservative basis. Banks today are concerned about the risk of their loans and many are working to shore up their own capital.

Recapitalizations: I really expected to see more recapitalizations, but I have not seen all that many. It would make a lot of sense with multiples being down, for those owners who would like to take some cash now, and remain a large shareholder. They then can cash out the remaining portion of their interest at a later date, hopefully after the market improves, rather than sell the entire company now at a lower multiple.

Multiples: It is my opinion that multiples have probably hit bottom. Today the multiple is more about financing than it was a year or so ago. Even large companies are not getting big multiples as they once did. I don't see them edging up until financing gets easier.

What is Selling: Business products and services, healthcare, information

technology; for the most part, manufacturing is down except for food and food related companies, with construction, building materials and automotive at the end of the list.

2009 isn't going to be a good year for M&A transactions. The collective consensus of most surveys seems to be that the second half will improve and some even think it will explode. I don't think the third quarter will see much improvement but the fourth could see minor increased activity. The M&A market can't come back until the banks and financing sources do. The key to making the right decisions is still through good due diligence, sound thinking, reasonable pricing and good advisors.

Charles K. Oppenheimer is founder, chairman and CEO of Amvest Financial Group, Inc. an investment bank advising a wide variety of companies in mergers, acquisitions and corporate finance matters. He also serves as co-vice chairman of Skyview Capital and is a director of Halkon Investments both private equity groups and serves on numerous corporate and advisory boards of privately held companies.

Delves, from page 54

excessive and are beneficial to the company and shareholders.

- B. Establish "Rules of the Road" for existing incentive plans.
- C. Define guidelines for how major and minor transactions will be incorporated into performance measurement for annual and long-term incentive plans (For example, will additional revenue and earnings generated from an acquisition be counted towards annual incentive plan goals? These issues should be addressed and resolved before embarking on the M&A trail.)

Don Delves is founder and president of The Delves Group, a Chicago-based consultancy dedicated to working with boards, compensation committees, senior executive teams, and sales forces to improve their effectiveness and the way they are organized, directed, and rewarded. He has advised more than 100 board compensation committees over 23 years, and attends 50-60 compensation committee meetings per year. Delves' book, *Stock Options and the New Rules of Corporate Accountability: Measuring, Managing, and Rewarding Performance* (McGraw-Hill, 2003; WorldatWork, 2006) in its second edition, is considered a "must-read" for board members, executives, and investors. Delves also published *Accounting for Compensation Arrangements* (CCH, 2006, 2007, 2008), the definitive guide for accounting for stock options, equity incentives, and other forms of compensation.

Richard Throe recently joined the Delves Group as a Senior Consultant after acquiring his MBA in Analytic Finance and Accounting from the University of Chicago, Graduate School of Business. Richard has over 13 years professional consulting experience with Mercer, Accenture, and Watson Wyatt. Rich is also on the board of the Chicago Symphony Orchestra Associates and is a member of the Union League Club of Chicago.

An M&A Executive Compensation Checklist

By Don Delves and Rich Thoroe

Steps to ensuring a successful transaction.



Don Delves

Executive compensation is a powerful tool for motivating a company's management team to grow the value of the corporation and accomplish its strategic objectives. Executive compensation can also be a powerful tool to influence positive outcomes in M&A activity. However, recent transactions like the acquisition

of Merrill Lynch by Bank of America remind us of the potential for executive pay to get out of hand during a deal. Improperly structured incentives and golden parachutes can also present expensive roadblocks to otherwise desirable transactions. With the recent public outcry over executive compensation, directors now more than ever need to be vigilant when overseeing the role of executive compensation during M&A events. The following checklist covers the key questions that should be addressed by boards when considering a major corporate transaction:

I. What is the responsibility of the board during a merger or acquisition (in terms of exercising duty of care and sound business judgment)?

- A. In the case of a sale: ensure that the shareholders get the best possible price for the company.
- B. In the case of a purchase: transaction is aligned with shareholder interests, paying a fair price, appropriate strategic fit, appropriate cultural fit, and everyone knows what they are buying (due diligence).

II. What are the key issues a board should consider in terms of executive pay during the transaction?

- A. If selling the company:
 - 1. Ensure that the appropriate incentives are in place to motivate key management to stay with the company, maximize its value, and facilitate a smooth sale.
 - 2. Do employment contracts exist? Then revisit change-in-control provisions in employment contracts to ensure that they:
 - a) Protect key members of the management team,
 - b) Are attractive to potential buyers (eliminate potential deterrents and poison pills),

- c) Will generally be perceived as fair and reasonable.

B. If purchasing a company:

- 1. Ensure that the appropriate incentives are in place to motivate key management to stay with the company through the acquisition.
- 2. Ensure that the company is paying a fair price for the incoming management team.
 - a) Careful due diligence and review of salary levels, incentive plans and employment contracts
 - 1) Who has them?
 - 2) Are there any special 'side deals' or retention bonuses?
 - b) Carefully analyze all golden parachute provisions:
 - 1) How much will senior management be paid:
 - (a) At the time of the transaction?
 - (b) If terminated after the transaction?
 - 2) Are the parachutes beneficial or detrimental to the transaction?
 - 3) Does management have an incentive to stay with the company, or receive so much money they can easily leave?
 - 4) Can the terms be re-negotiated to your benefit?
 - c) Assess the compatibility of the compensation programs:
 - 1) How do pay philosophies and practices of the two companies compare?
 - 2) How will differences be resolved?

III. Preparation is essential:

- A. Stay on top of succession planning. This will help you understand where the key talent lies within your organization and identify any gaps. Understand who would be attractive to a potential buyer—figure out who the company needs to keep during a potential sale or merger.
 - 1. Are employment contracts necessary or will a well-designed incentive plan be sufficient to motivate and retain talent?
 - 2. Employ purpose-driven change-in-control planning to make sure parachute provisions are not

continued on page 53