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A Beacon In the Storm

A lead director's responsibilities in M&A transactions.

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Recent years have seen marked changes in the role played by directors of U.S. public companies. Prominent among these trends is the broader role ascribed to, and the heightened responsibility placed upon, lead directors.¹ The lead director position has become not only a mechanism for fostering effective internal relationships—such as coping with underperforming directors and strengthening the relationship between the CEO and the board—but has evolved into an important position during extraordinary circumstances.

The focus of this article is directed at the latter situation: When a company faces a takeover bid or considers whether to engage in M&A activity, what role should a lead director play to ensure that the board and

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management act in a measured, orchestrated manner designed to advance the best interests of the corporation and its shareholders? The importance of this question has only been magnified by the recent crises in the financial institutions arena, where ongoing events have made clear that executing, or not executing, a successful M&A transaction can make the difference in whether or not an institution survives.

Evolution of the Role

The position of lead director began somewhat inconspicuously in the late 1980s and early 1990s, with a handful of public companies creating the role on an ad hoc basis to address discrete issues. Many of these early efforts focused on such specific issues as retaining new management or locating replacements for board vacancies, although in a few cases some lead directors spearheaded preliminary efforts, in concert with outside consultants and advisers, to evaluate potential strategic transactions.

The most notable watershed event in the creation of a permanent lead director post was General Motors' establishment of such



position in 1994 as a direct consequence of a series of meetings by that company's outside directors who were concerned by the performance of their chairman and chief executive.

The landscape changed drastically, however, following the well-publicized corporate scandals from 2001 to 2003. Shareholders, regulators and company boards alike began calling for more concrete standards of director accountability and supported initiatives designed to increase the non-management directors' engagement in the corporate decision-making process. Some commentators went as far as pushing for the adoption of the UK model of governance, with full separation of the chairman and CEO positions, as appropriate

remedial action.

Rather than implement this profound change, stock exchanges as a compromise adopted new listing requirements concerning the role of independent directors generally and lead directors specifically. Both the NYSE and NASDAQ now mandate that companies regularly schedule executive sessions of independent directors and that shareholders have the ability to communicate with those directors. For its part, the NYSE went a step further by requiring that a "presiding" director be designated to convene meetings of the independent directors. The 2004 Blue Ribbon Committee Report of the National Association of Corporate Directors supported these standards, while recommending that the roles of a company's CEO and its lead director be more clearly defined.

As the lead director position has become a more accepted staple of American corporate governance,² the responsibilities of these individuals have not remained static and continue to evolve. Fueled in part by the scandals mentioned above, shareholder activism has accelerated in recent years. Hedge funds and other institutional investors constantly press company boards for more stringent oversight of management.

As these investors and proxy advisory firms like Risk Metrics/Institutional Shareholder Services seek to nudge the barometer of what they view as "best practices," the lead director's duties have expanded. For example, in the 2008 proxy season, Risk Metrics/Institutional Shareholder Services mandated that a company with a combined CEO-chairman disclose a comparison of the duties of its lead director versus those of its chairman and explain why the company decided not to give the chairman position to its lead director. Pressure such as this seems to elicit results: according to the 2007 Spencer Stuart Board Index Report, 35 percent of S&P 500 companies now divide the responsibilities of chairman and CEO between two individuals, up from 25 percent in 2002. Thus, a timely understanding as to the full scope of the potential responsibilities of a lead director should assist these individuals in discharging their current duties with a view toward

preparing for issues on the horizon.

Lead Director Role in M&A

The precise role of a lead director in M&A activity typically hinges upon the facts and circumstances of the potential transaction being considered. Is the company the acquiror or the target? If the company is the target, is a financial buyer involved or is a strategic bidder in the picture? Is the transaction a friendly transaction or is the company the subject of an actual or threatened hostile takeover?

Recognizing that the nuances of a lead director's responsibilities vary depending on the answers to these questions, this article seeks to highlight the value a lead director can bring to bear in the context of (1) the company as the acquiror, (2) the company as the target, pursued by a financial buyer, (3) the company as the target, sought by a strategic bidder and (4) the company facing a hostile takeover.

The Company as the Acquiror. As a general point, a board of directors that fully understands the company's long-term strategic goals is, of course, more likely to execute successful transactions. Accordingly, a lead director often can play an important role in working together with management and the other board members to develop and articulate a long-term growth strategy for the company. Having been closely involved in the development of the corporate strategy and having embraced it, the board will be in a better position to evaluate whether a proposed acquisition is consistent with and in furtherance of that strategy.

When a specific potential transaction arises, board members should thoughtfully understand the risks and benefits of the deal, why the acquisition is being proposed and how the transaction fits within and advances the larger strategic aims of the corporation. The due diligence process, both financial and legal, is critical. "Red flags" arising from the diligence process should be identified and thoroughly investigated with a view to informing the directors of the risks the transaction poses so that an informed decision may be made as to how, and whether, to proceed. To this end, a lead director can play an indispensable role in ensuring that the right questions are asked and

that such inquiries are answered in a timely and complete manner. This means, of course, that the board should have sufficient time to allow it to confirm that the assumptions underlying the acquisition of the target company are met.

The Company as the Target: Financial Buyers. Transactions involving financial buyers present special issues for directors, including the possibility that management directors will remain with the company following the sale to the financial buyer. The fiduciary duty of loyalty requires that directors avoid personal conflicts while pursuing the best interests of the corporation and its shareholders. Because financial buyers often seek to retain company management, some of whom (including the CEO) may be directors, to run the company following the transaction, the appearance of this particular type of conflict of interest may suggest to a reviewing court that management directors have an incentive to act in ways adverse to the interests of the shareholders generally. For instance, if a particular bidder offers a more favorable compensation package or a larger equity participation to management directors than another bidder may offer, a court would negatively view any bias that such management directors may have in the sale process toward that bidder which is not directly connected to maximizing the price received by the shareholders generally.

Given the inherent conflict of interest presented by these situations, it often is natural in these circumstances for a lead director to play a more active role. Depending on the circumstances and management's expected role with the buyer following the transaction, a lead director can assist in determining whether and when to form a special committee of independent directors to conduct and actively oversee negotiations with the buyer, as well as working to identify with the assistance of counsel which directors are best situated to serve on such a committee.

Because of a lead director's unique communication position, he or she can articulate to management, in a constructive manner, the necessity of keeping the board fully and timely informed of indications of interest and of avoiding solicitations of interest directed at third parties without prior board and committee authorization. In

this same vein, a lead director might remind management to resist casual conversations with bidders regarding future compensation or equity packages, and could help formulate a structured negotiation process to ensure that such packages are hashed out only after the special committee has reached agreement with the buyer on the substantive transactional terms. Simply put, by taking an active role in the process, a lead director can assist in reducing the risk of successful lawsuits challenging board actions in conducting the sale process where a financial buyer is involved.

The Company as the Target: Strategic Buyers. Depending on the circumstances, a sale to a strategic buyer may create unique conflict of interest scenarios for directors and executives. For example, management directors could receive lucrative change of control or severance payments as a result of a successful transaction and thus may be seen by the courts as having an incentive to unduly favor a transaction to obtain these payments. Moreover, a completed transaction may advance less traditional sources of self-interest for directors, including the extinguishment of viable derivative lawsuits brought by aggrieved shareholders against board members (an argument that has been made on several occasions where transactions were completed involving corporations that were at the time facing lawsuits based upon the alleged backdating of stock options). Again, by playing a more active role in the process, a lead director can spearhead the board's effort to identify and mitigate any perceived conflicts of interest presented by a potential transaction.

Perhaps the most important role a lead director can play in a sale to a strategic buyer—or to any buyer for that matter—is to assist in orchestrating a decision-making process that not only provides the board with timely information necessary to discharge its fiduciary duties, but that positions board members to be active participants throughout the course of the sale. Recent legal decisions have emphasized the notion that involvement in the negotiation and structuring of a transaction should not be limited to executive management alone. In *Ryan v. Lyondell Chemical Co.*, C.A.

No. 3176-VCN (Del. Ch. July 29, 2008), the Delaware Court of Chancery leveled heavy criticism at a board of directors for not engaging in proactive measures to determine the value of the company in the months leading up to the sale, for failing to solicit interest from other potential acquirors and for delegating virtually all of the substantive negotiations with the buyer to the company's CEO.

In light of the *Lyondell* case and others like it, a lead director should help ensure that management keeps the board reasonably apprised of financial valuations of the company, of the deal environment and of the company's expected future performance. If reliable evidence shows that the company may become a target, a lead director can provide invaluable assistance in retaining appropriate legal and financial advisers to evaluate strategic options. In sum, a lead director's pioneering of advance preparation for a potential transaction should result in more robust information upon which directors can make decisions and should allow the transaction process to advance the company's best interests in an efficient fashion.

The Hostile Takeover. As a matter of course, effective board leadership requires that directors understand the relative likelihood of unwanted takeover interest in the company. Lulls in performance caused by temporary weaknesses such as failed transactions, integration difficulties or realignment of strategy may leave a company vulnerable to a hostile bid that in some circumstances could be perceived as not providing adequate value to the shareholders in view of the company's long-term prospects.

Depending on the company's ownership structure, a lead director, along with the company's legal advisers, can work with the other directors and management to implement the appropriate mix of anti-takeover devices (such as advance notice bylaws or a shareholder rights plan) warranted by the circumstances. A lead director also can coordinate with management and other directors to articulate and update the company's long-term strategic vision and goals, items that may provide critical evidentiary support in the future if the

board considers, and ultimately rejects, an unsolicited purchase offer.

The role of a lead director as an independent voice of the board to the company's shareholders cannot be underestimated. Shareholders who are kept abreast of the company's future goals and anticipated performance, and who are cultivated to trust directorial oversight, are less likely to perceive anti-takeover measures or rejected offers as attempts by management to entrench themselves in office. In addition to providing candid disclosure and cultivating shareholder trust, lead directors can assist in creating a blueprint for the board to remain informed about trading in the company's securities and communications by activist investors. Fluid shareholder communication, and keeping the board members up to date on shareholder relations, are key preparatory actions a lead director can take that are likely to pay dividends in the event an unsolicited takeover bid occurs.

Conclusion

Recent events, particularly in the context of the crises in the financial institutions arena, have highlighted again how important it is that the board and management effectively evaluate, consider and implement M&A transactions. These circumstances are likely to place even more focus on the role played by the independent directors of public companies engaged in M&A transactions. As a result, the lead director's role in this context, as well as other contexts, will continue to evolve to fit the changing landscape.



1. In this article, the director serving as "presiding" director, "lead" director or non-executive chairman is referred to as a "lead director."

2. According to the 2007 Spencer Stuart Board Index Report, 94 percent of S&P 500 companies had a lead director, up from approximately 33 percent in 2002.