

## Lecture 8 (Notes by Leora Schiff)

15.649 - The Law of Mergers and Acquisitions (Spring 2003) - Prof. John Akula

### Sarbanes-Oxley

- I. New Rules for Directors and Officers
  - a. CEO/CFO certifications
    - i. Section 906
    - ii. Section 302
  - b. Internal Controls
  - c. No loans to directors/officers
  - d. Insider trading
  - e. CEO/CFO disgorgement penalty
  - f. Code of ethics
  
- II. New Requirements SEC reports
  - a. 10-K, 10-Q
    - i. auditor identified adjustments
    - ii. off-balance sheet transactions
    - iii. internal control report, etc.
  - b. faster 8-K disclosure
  
- III. New Section 16 Reporting Requirements
  - a. Directors, officers and 10% shareholders must report stock transactions within 2 business days
  
- IV. New Rules for Audit Committees and Auditors
  
- V. New Sanctions against Corporate Fraud
  - a. Prohibitions against destruction of documents
  - b. Protections for whistleblowers
  - c. Changes in penalties
  - d. Enforcement changes
  
- VI. SEC rules on earnings releases and non-GAAP disclosures

# Legal Liability of Managers and Board Members

## I. Power of the Board of Target to Block Takeovers

### a. Friendly vs hostile takeovers

### b. Hostile Takeover defenses

#### i. Defenses requiring shareholder ratification

1. shareholder vote required
  - a. take time
  - b. not flexible
2. shark repellent certificate amendments – used to prevent someone with newly acquired voting power from taking over BOD
  - a. staggered BODs
  - b. eliminating shareholder votes through written consent procedure – forces shareholder meetings
  - c. etc. pg. 234-7
  - d. supermajority vote for combination of target and acquiring firm if hostile
  - e. time-phased voting plans – changes voting rights of outstanding common stock

#### ii. Defenses put in place by BOD through general authority contained in certificates or articles of incorporation

1. if power not in articles, shareholders have to vote to amend articles
  - a. faster
  - b. don't have to justify in proxy statements
2. poison pill plans
  - a. dividend distribution to existing shareholders of stock, stock rights or other securities that have special redemption or conversion provisions.
  - b. Conversion options triggered by hostile acquisition
  - c. Effect – target too expensive to buy without BOD approval
  - d. Leveraged recapitalization – target exhausts debt capacity and free cash – can't be acquired using own assets to pay for acquisition

- iii. Defenses of BOD based on state corporate code
      - 1. shareholders do not vote
      - 2. sale of assets – crown jewel defense
    - iv. Shareholders can vote to remove defenses from ii and iii
  - c. State anti-takeover statutes – pg. 240-246
  - d. Court review of BOD decisions to block hostile takeovers
    - i. Void defenses
    - ii. Unocal standard
      - 1. reasonable – perception of threat real
      - 2. proportional – action merited by level of threat
- II. Decision of the Board of Target to Sell the Company
  - a. Court tests for judging the actions of a selling firm's board:
    - i. Business judgment rule
      - 1. basic standard for court review of BOD decision to sell a firm to a single suitor
      - 2. if applies, BOD protected from second guessing by courts
      - 3. to lose protection of business judgment rule, board members need to be:
        - a. grossly negligent
        - b. reckless
      - 4. BJR doesn't apply if
        - a. Duty-of-loyalty cases - Proof of fraud, bad faith, self-dealing
        - b. Duty-of-care cases - Uninformed decision making
          - i. Protections –
            - 1. fairness opinion
            - 2. documented in-house comparables valuation
            - 3. documented board deliberation
      - 5. If BJR doesn't apply, courts evaluate deal under Entire or Intrinsic Fairness Test - Deal must be entirely fair to shareholders
    - ii. Enhanced scrutiny test (Unocal test) –
      - 1. applied to auctions when BOD favors one bidder over another
    - iii. Intrinsic fairness test –
      - 1. when BOD operating under conflicts of interest

**b. Deal Protection Measures**

i. Purpose

1. economic compensation for jilted purchaser in event target chooses not to close
2. obstructs disruption of deal by another purchaser

ii. Types of covenants

1. no-talk clause – blocks sharing of confidential info by target with other suitors
2. no-shop clause – limit on target's soliciting other bids
3. requirement that target managers use best efforts to close merger
4. goodbye kiss - termination fee
5. lock-up option – option granted to purchaser to acquire stock or assets of target if deal does not close

iii. Fiduciary Out clause – provide target company with escape hatch

1. directors are excused from actions that would constitute violation of fiduciary duty – would allow target BOD to negotiate with third party despite no shop clause

**c. Court Review of Cases of Multiple Bidders**

i. Issues

1. Has company put itself up for sale? Yes if:
  - a. Initiates auction
  - b. Initiates transaction resulting in change of control –
    - i. Change of control occurs if majority of stock ends up under control of single individual/small group of individuals
    - ii. Does not occur if stock transfers to diffuse group of shareholders
  - c. Initiates bust up of company's divisions
  - d. Any of the above constitute the Revlon Zone –
    - i. courts will use enhanced scrutiny in these cases (far beyond business judgment rule)
    - ii. focus – did BOD get best deal for shareholders?
2. If put itself up for sale, BOD decision has to satisfy entire fairness test
  - a. Must sell to highest bidder
  - b. Unless BOD actions can satisfy modified Unocal standard – 2 part test:
    - i. Reasonableness
      1. ex. One bidder unlikely to be able to finance acquisition
    - ii. Proportionality

- d. **Deal structure matched to court evaluation**
  - i. Business Judgment rule
    - 1. Stock for stock merger
  - ii. enhanced Revlon duties
    - 1. Cash acquisition
    - 2. Target shareholders given choice of cash or shares in Acquirer
    - 3. Deal protection clauses –
      - a. currently unclear how whether Revlon or BJR applies
      - b. safest to include fiduciary out clauses
      - c. less stringent application of enhanced scrutiny in case of strategic mergers – deal protection clauses may be viewed as appropriate by courts
- e. **Court review of Management Buyout Offer**
  - i. Conflict of interest exists (management both sellers and buyers), therefore:
    - 1. business judgment rule unavailable
    - 2. board's decision must meet entire/intrinsic fairness test
  - ii. If plaintiff alleges conflict of interest, burden of proof on BOD. Need to prove:
    - 1. fully informed shareholders ratified board decision or
    - 2. subcommittee of disinterested board members (Special Committee) acted independently and with sufficient information
    - 3. if either 1 or 2 shown, burden of proof shifts to plaintiff to prove fails test of entire fairness