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A publication of Directors & Boards magazine

Mergers & Acquisitions



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'Why Did You Make That Acquisition?'

By James Kristie

That's one question a management team never wants to hear from its board—nor should it.



James Kristie

The topic of the board's role in mergers and acquisitions is quite close to my heart. For a spell during my early years as editor of **Directors &**

Boards I did double duty as a senior editor of *Mergers & Acquisitions*. Both journals came as a package in an acquisition made in 1980, so I had the opportunity to take on corporate governance as my proverbial major, with a minor in the art of M&A.

The early '80s, as it turned out, was a great time to get in on the ground floor of a merger wave that would wash over Corporate America. A tsunami of M&A deal making changed the landscape of what companies and industries looked

I loved every minute of it, actually. It gave us a lot to write about. But it was not a lovely time in boardrooms. There was a lot of anguish generated, not just by the raiders but also by the bankers who gleefully teed up targets and by boards who, overcome by animal spirits, made moves both as hunter and hunted that were often unhinged from economic rationality.

Some of the best advisories on governance we published in the pages of **D&B** during the '80s were merger-related. When an offer, either welcome or unwelcome, hits the CEO's doorstep, that's when shareholders really count on the board doing the right thing.

I've been reviewing these past M&A advisories as I develop the "Wisdom of the Ages," the theme of **Directors & Boards'** 30th anniversary issue to be published in October 2006. I'll share

into an outfit named Enron). He laid out a set of brilliant tactics, and the one he saved for last—"because I can't overemphasize it"—is this:

"Don't Impose Your Standards to the Absolute. When you buy a company, you are buying a performance record. This is a company that made it the way they were structured and managed, not the way you are. You want to sustain the culture that has achieved that record. Start imposing new people, new requirements, new values, and suddenly you don't have what you thought you bought.

"When we acquired Belco Petroleum, we merged our exploration and production operations with theirs. Both were about the same size, but our cost of finding oil was twice that of Belco's. Now which management do you run with? As basic as that sounds, it is not a common decision, and because of the interpersonal relationships involved in any merger, it can be an agonizing decision. But you want the record you bought to continue. Do anything to jeopardize that, and sooner rather than later you'll have your board asking you, "Why did you make that acquisition?"

M&A history is replete with case studies of company wreckage and thwarted ambitions left in the wake of a deal. This *Boardroom Briefing* is designed to help guide you in your M&A oversight and preempt the need for head-shaking postmortems.

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

Ultimate success rests with smart treatment of the talent that comes with the property.

like and even how business was done. Forget any gentlemanly arrangements for putting two organizations together. I remember the decade of the '80s as a wild and wooly time of raiders and restructurers. It was not at all unusual to open the pages of *The Wall Street Journal* in the morning and have the front-page "What's New" column be filled with offers, counteroffers, offer rejections, done deals, "floating balloons," and hit lists of who'll be next to wake up with a ravenous acquirer at their doorstep.

with you one of the preeminent pieces of advice I found: It's all about people. Ultimate success rests with smart treatment of the talent that comes with the property.

Here is a powerful testimonial to that principle. It's from one of my favorite advisories, "Seasoned Advice from the Merger Arena," published in 1985, right in the heat of the M&A land grab. The author is Sam Segnar, chairman and CEO of an energy company called InterNorth Inc. (that would later that decade morph



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Making the Best of M&A

By Jay W. Lorsch

How boards can improve the success rate of M&A activity



Jay W. Lorsch

Since the corporate scandals of 2001 and the passage of the Sarbanes-Oxley Act, board members have found themselves

heavily involved with issues of compliance to new rules, especially those pertaining to financial reporting. New SEC regulations about reporting executive compensation are likely to further occupy directors' time. These changes in the boardroom environment frustrate many directors who believe a more important responsibility should be to oversee their company's strategic direction.

What is not always clear to these directors, or to me, is precisely what they mean by "strategy." Do they simply want more involvement in matters related to the functioning of the business, or are they concerned

or the acquiree, boards become involved in decisions about business combinations as a matter of company by-laws, charters, and custom.

Obviously this is not the only way boards become involved in company strategy, but it is one of the most significant in terms of frequency and impact. In addition, it is highly problematic because these business combinations frequently do not live up to either the board's or management's expectations.

What can boards do to improve the rate of success in mergers or acquisitions? Here are a few ideas.

Be Clear About Your Legal Situation

There is often a presumption by directors that their only legal obligation in such matters is to do what is in the best interest of their shareholders, especially when they receive an offer for their company.

about long-term goals and the means to attain them? However individual directors answer these questions, one fact is clear—at the heart of any board's strategic responsibility are decisions about mergers and acquisitions. Whether friendly or hostile, whether the acquirer

While directors should be concerned about shareholder value, this does not necessarily mean selling to the highest bidder. Nor should directors expect a target's board to automatically accept the highest offer. The laws are more complicated than that and include the right, under some

circumstances, to say "no thanks." Boards should consult with legal counsel to understand their legal options clearly and completely.

Do Your Homework. Ask the Right Questions.

Boards will receive a lot of information about such transactions from their management, lawyers, and financial advisors. These parties, however, may have motives that conflict with what is best for the company or its shareholders. To put it plainly, these folks often want the deal to go through because it is in their self-interest. Directors must be the objective partner in such deliberations and do their individual and collective homework to counteract such bias. To achieve this, board members must be well informed about their own company, as well as the other party, and they should be asking these kinds of questions:

- Are the financial projections/business plans realistic and valid?
- How might the current business environment change?
- What will the new company look like financially and competitively?
- Who will lead the combined company and what will the organization chart look like?
- What will the cultural fit be between the two organizations?
- What changes in personnel, financial structure, and competitive strategy will be necessary for the deal to work?

M&A is not the only way boards become involved in company strategy, but it is one of the most significant in terms of frequency and impact.



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Directors must be the objective partner in such deliberations and do their individual and collective homework to counteract bias.

Evaluate the Implementation Plan

Another reason business combinations fail is that while they are conceptually sound, the integration of the two entities fails to take place. It is, therefore, incumbent on boards to be as sure as they can be that there is a workable and comprehensive integration plan in place before they approve a deal. An especially important part of the process is ensuring that the management talent will be in place to bring about the transition. Consideration needs to be given to recruiting and retaining talent, succession planning, organization structure,

consultant to develop an employee retention strategy.

When Quickturn rejected the offer from Mentor, they entered into merger discussions with a “white knight,” Cadence Design Systems. The board once again focused its attention on employees, and by the time this merger occurred, the company had lost almost none of them.

Create a Highly Qualified, Dedicated Taskforce

To consider all these matters, it may be necessary or desirable to create a task force of independent directors. This taskforce should include board

all the information management and its outside advisors had used in recommending the acquisition. Further, they did their own “research.” Because of this thorough review, the full board embraced the taskforce’s positive recommendation.

Boards Must Remain in Control

As suggested above, decisions about potential business combinations usually involve directors not only with their management team but also with a multitude of outside advisors who can take too much control of the board’s deliberations. One way to prevent this is to create a dedicated task force, as described above. But if this does not seem desirable or practical, all the independent directors should spend sufficient time in deliberations among themselves—away from management or advisors—to make certain that they are acting independently.

All the independent directors should spend sufficient time in deliberations among themselves—away from management or advisors—to make certain that they are acting independently.

and communicating with employees at all levels.

An example of a board correctly focusing on employees occurred with Quickturn Design Systems, Inc. In 1998, Quickturn was approached by Mentor Graphics in a hostile takeover attempt. In the first meeting of the Quickturn board after the offer was made, directors paid considerable attention to employee welfare, since retaining talent was critical to Quickturn’s success, whether it remained an independent entity or not. As a result, the board immediately hired an independent human resource

members that have the expertise, time, and ability to conduct a detailed evaluation of all aspects of the negotiations and deal. Their mission is to raise all issues (both short- and long-term) to ensure that management and outside advisors have thoroughly considered and evaluated all outcomes.

When Luken Steel sought to acquire Washington Steel Corporation in 1991, for example, the newly appointed CEO, who had formerly worked for Washington Steel, assembled a taskforce with this goal in mind. This group of four independent directors reviewed

The role of corporate boards has changed significantly in recent years. But to make even more progress, directors need to take their role in approving company strategy seriously. Nowhere is this more apparent than in mergers and acquisitions. If boards follow these recommendations, chances are that the business combinations that make it through this process—fewer though they may be—will be more likely to succeed.

Jay W. Lorsch is the Louis E. Kirstein Professor of Human Relations at Harvard Business School.

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The Board's Role in M&A

By Ian Cookson

Increased scrutiny demands boards and directors become more involved in mergers & acquisitions



Ian Cookson

Just as counselors say that marriages based on the premise that 'she can change him' do not have a stellar record, mergers and acquisitions are not that different.

In no area is the importance of an independent board arguably greater than in carefully evaluating acquisitions. History demonstrates transformational acquisitions are almost unrivalled in their staggering ability to destroy value for shareholders—AOL Time Warner is but one in a long list of such examples. Boards should therefore focus enormous attention on evaluating acquisitions, particularly addressing reasons most commonly given for past failures. Our surveys suggest the reasons most frequently cited for failure of acquisitions are poor integration planning, lack of strategic rationale and weak cultural fit.

Conversely, a good match, thorough planning and effective personnel are the reasons most frequently cited for an acquisition succeeding. To that end, a comprehensive review of these elements is integral to the board's role in mergers & acquisitions. And the question becomes: What can and should directors do in each of these areas?

Integration Issues

Directors should ask to review the post-acquisition integration plan

and determine who is accountable for its implementation. This would likely cover three areas: (1) those actions immediately necessary after the transaction closes, frequently a laundry list of housekeeping items; (2) the communication plan, covering not only short-term communication with customers, shareholders and employees but also ongoing communication to address primary concerns of key stakeholders based on solicited feedback; and finally, (3) the plan for delivering intended synergies, not only in regards to cost savings through consolidation, purchasing synergies, etc., but also pertaining to those actions intended to expand revenue.

These plans would highlight ongoing processes to generate new performance improvement ideas as the organizations learn to work together. Where realizing synergies is critical to supporting the price paid for a target, the board will want to carefully consider these synergies and understand how difficult they will be to implement, as well as their likelihood of success.

Strategic Rationale

Executives will want to demonstrate to the board how the acquisition

will leverage the strengths of the acquirer and/or resolve important vulnerabilities. They will also want to address the closeness of fit with the existing business, as research shows the further away the core activities are of the target to that of the acquirer, the less successful the acquisition tends to be. Information and due diligence reports on the target should also be provided to the directors, so they can gain comfort the business really is what management thinks it is, rather than what they want it to be.

Sadly, we have numerous examples where the underlying economics of the target have not reflected the story of the business as it has been presented. Just as counselors say that marriages based on the premise that 'she can change him' do not have a stellar record, mergers and acquisitions are not that different.

Cultural Fit

What is the target's current culture and how does it differ from that of the acquirer, as well as what does that imply for how the partners must behave going forward if the acquisition is to be successful? The board should again view people and culture from a risk perspective. That is, if the culture and ways of



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doing business differ markedly or significant personnel changes are required, the risk of the transaction is far higher.

In one recent example, an acquirer replaced the entire management team after an acquisition, which was not in and of itself bad, but when combined with a high purchase price, substantial financial leverage and a volatile revenue stream, the resulting disruption proved catastrophic.

Where certain members of management are central to the businesses ongoing success, the board should be informed of retention and incentive plans for those key players. Culture is a crucial element for the board to grasp including those attributes of the target's 'ways of working' that

make the organization successful and the specific actions that will be taken to ensure those elements are retained and built on.

In another example, an acquirer changed many of the nuances and methods of working of an acquired company, which together made the target exceptional in the marketplace. The target's performance consequently fell back into line with industry norms, which combined with the full purchase price and debt load that came with the acquisition of an exceptional business, provided no room for error.

The lesson in these examples is to understand, retain and build on the differences that led to the target's success and grasp how these components will operate with

the additional risk and stress placed on a business from the acquisition. This is exactly the perspective that greater board involvement can bring.

Independence and Conflicts of Interest

Board advisors are increasingly being used to help evaluate management's strategy, analysis and post-acquisition plans, with the advisors reporting to the board independent of management. This helps to ensure that a greater level of thought and justification is given to the spending of substantial funds and reduces the temptation to ignore the less exciting integration, cultural and key people issues after the deal is completed. It also provides a higher level of defense for board members that they acted in the

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exercise of their reasonable business judgment. The pursuit of the right evaluation process is a board's best defense against litigation, demonstrating deliberation and analysis performed by independent experts.

Directors are expected to avoid conflicts of interest, keep themselves informed and have a reasonable analysis of a proposed transaction. In reviewing significant acquisitions as in other material matters affecting a company, the board should always keep in mind their duty of loyalty and duty of care, according to Dennis White, an attorney with the Boston office of McDermott Will & Emery LLP. In order to discharge their duty of care, a board will generally avoid being second-guessed by a court if the board members follow the so-called

business judgment rule, that is, they follow a process that is deliberate and thoughtful and in which they ask the right questions. "One-hour quickie meetings are generally viewed as largely rubber stamps exercises and can be downright dangerous for a board member," says White.

At a minimum, it is likely for defensive purposes that board members will want to document their deliberations and analyses of such areas as: strategic rationale for the transaction, other acquisition

alternatives explored and why this potential target is most advantageous, due diligence process and findings, valuation and support for projections, suitability of the financing structure being adopted, post-acquisition plans to deliver intended benefits, and plans to address key people and cultural issues.

The board will also want to know there are no hidden liabilities (e.g. environmental problems, ERISA noncompliance, intellectual property litigation, etc.) that could turn promise into failure.

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Directors' M&A "Cheat" Sheet

What are the integration plans?

- short-term actions
- communication plans (immediate & ongoing)
- synergy delivery plans (& likelihood they will be achieved)
- internal controls compliance plan
- individuals accountable

Is strategic rationale robust?

- closeness of fit with existing business
- acquisition's ability to leverage strengths & resolve weaknesses
- do economic realities match the story
- other targets/options explored

How will we manage implications of people & culture?

- closeness of cultural fit
- implications for future ways of working
- retention & rewards for key people
- what it is that makes the business successful
- how this will be retained & built on

Viewing risks (above) in context of price

- valuation, comparables, projections, revenue risk, financing structure
- fairness opinion is independent from deal fee
- due diligence is robust (internal & external) and directed to uncovering any significant potential liabilities

Board litigation protection

- process, deliberations & analysis documented
- use of independent experts

Value added by board members

- from personal experiences
- not simply monitoring management
- balanced perspective to weighing risks & rewards

In the past, fairness opinions have been used as a defense to provide protection to board members regarding the price paid for an acquisition. This area is now also under review, with the NASD conducting an inquiry into fees, methods and possible conflicts of interest, as the investment bank rendering its opinion is frequently the same one with a sizeable success fee riding on the outcome of the transaction. As a result, in order to

Audit committees are also expected to be more involved in significant transactions, gaining an understanding of the target's accounting policies and obligations (including off-balance sheet items). In addition, heightened internal control requirements under Section 404 of the Act suggest public acquirers will also want to integrate financial reporting processes as soon as possible, though the SEC has offered some relief on the timing of implementation of Section 404 following an acquisition.

Directors are expected to avoid conflicts of interest, keep themselves informed and have a reasonable analysis of a proposed transaction.

provide the protection boards are seeking, they should ensure fairness opinions are independent and addressed to the board itself.

Due Diligence

Over and above the higher requirements of good governance, the Sarbanes-Oxley legislation has heightened the level of due diligence for public companies and added certain specific due diligence requirements. Since the acquiring company's management will need to sign off personally on the financial statements of the combined entity after closing, they will want to ensure they have the same level of comfort about the target's financial information as they have of their own. Although acquirers can gain some comfort from representations and warranties of the seller, these do not reduce management's own personal responsibilities.

Nevertheless, developing a compliance implementation plan covering internal controls and financial reporting for after the deal closes is a step towards compliance, and is exactly the sort of planning audit committees should be asking to see.

In this environment it is important that boards use their expanded role to not only monitor management, but to also increase the probability of successful acquisitions by adding value through their additional guidance and experienced counsel. This more rewarding position, helping to build the business and pass on lessons from their own experience, is after all the reason they joined the board in the first place.

Ian Cookson, corporate finance director, Grant Thornton LLP, advises clients on acquisitions, capital raising and the sale of businesses and can be reached at (617) 848-4982 or ian.cookson@gt.com.

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Six M&A Transition Principles for Boards

By Bruce Myers and Jim Peters

How boards can help ensure acquisitions deliver promised shareholder value



Bruce Myers

Every study over the past decade regarding M&A value creation has come to the same conclusion: The acquiring company, in roughly two-thirds of cases, does not realize the planned synergies, and as a result destroys some amount of shareholder value.



Jim Peters

Problems usually do not occur during the transaction phase—where the board is typically more heavily involved—but during the transition phase where rapid execution of key priorities must be completed. Based on our experience in the corporate turnaround, restructuring, and performance improvement business, we have discovered two fundamental M&A truths:

1. The process of integrating two companies, whether it is termed a merger or an acquisition, must be treated with the urgency and focus applied to a turnaround situation.
2. Most companies who have not done many acquisition integrations will strain to find

the capacity to do the integration while continuing to run a successful business.

Boards can help the company ensure it does not fall into the two-thirds of mergers that are unsuccessful by ensuring that their management has thought through the answers to some key questions during the transition.

Our experience shows all successful transitions have six important elements in common: rigorous value measurement, speed, customer

It is a massive job to integrate the operations of two organizations, and expecting the management team to do that while continuing to operate the business—in effect doing two more-than-full-time jobs—is a recipe for disaster.

retention, addressing the tough issues early, communication, and a small experienced full-time team focused on driving the transition. Here are some specific questions a board can ask its management team to help them proactively address these key areas.

Is There a Rigorous Value Measurement Process in Place to Show Monthly Progress?

The overall measure of merger success for shareholders is the increase in operational cash flow (or EBITDA) that is generated by the newly combined company. Management must clearly define, quantify, prioritize, and measure the achievement of operational cash-flow targets. This is a critical ongoing process. While it is understood intellectually, it is most often fumbled in executing the transition. Below are the three keys to success in this area:

- Management must establish a detailed pre-merger baseline so it can measure the improvements achieved. It is amazing how many times this simple step is not done in a rigorous way, leading to ongoing debates regarding actual improvement. Without a clearly communicated baseline, value created (i.e., the increase in operational cash flow) is difficult to measure. The process for defining the original baseline becomes more difficult as the integration process progresses.
- Hold individuals and teams accountable for achieving results by assigning specific targets and, if possible, tie incentives to achievements as a tool for teambuilding and focus. Incentives can be powerful forces in pushing managers to work cross-functionally, plan aggressively,

THE SIX PRINCIPLES

It is impossible to over-measure the value created during the merger integration process.

It is impossible to go too fast in executing a merger (as long as the execution plan is sound).

It is impossible to focus too much on your high-value customers during the transition phase.

It is impossible to identify and plan for solving the tough issues too early in a transition.

It is impossible to over-communicate in executing a merger.

It is impossible to assign a team with too much experience to the integration.

and drive required actions to ensure targets are met.

- Develop a detailed measurement system and process to capture planned and achieved value. This is required not only to track the progress toward the achievement of targets, but also to enable incentive tracking. In addition, a strong measurement system can support compelling success stories to keep employees focused and motivated, customers and shareholders excited, and competitors on the defensive.

It is impossible to over-measure the value created during the merger integration process.

Is the Transition Team Focused on Speed?

Speed is probably the most important factor in a successful integration. Its importance is due, in part, to simple financial considerations: the faster the combination achieves cost savings and revenue enhancement, the larger the net present value of the operational cash flows and the greater the return on investment.

But speed is also important for organizational reasons. Management

can harness the energy unleashed by a merger to accomplish significant change. The merger announcement has a way of unfreezing an organization—but it creates just a small window of opportunity. Initiatives not undertaken within the first 90 days after the close are unlikely to be tackled at all. The longer the transition takes, the more employees will gravitate back to the status quo, causing the loss of any early momentum and the potential stagnation of any major change initiatives.

It is impossible to go too fast in executing a merger (as long as the execution plan is sound).

Is There a Plan in Place with Specific Actions to Help Retain Existing Customers?

Time after time we have seen competitors take aggressive advantage of the transition period to steal customers. The specific tactics may vary, but the message is typically the same: “Now is a good time to give us a try; ‘we’ are focused on serving you while ‘they’ are focused on figuring out their new organization!” The competition may use specific sales commissions for taking away existing customers or direct mail and phone campaigns

to offer special incentives for customers to switch.

Management must expect and plan for it. The transition process must not only allow for, but also explicitly redouble efforts with specific programs to focus on retaining customers and providing high-quality service.

It is impossible to focus too much on your high-value customers during the transition phase.

Have the Toughest Issues Been Identified to be Addressed Early?

Support your management in identifying and resolving the toughest issues early in the process. Don’t wait for “early wins” to tackle the tough issues. Just as with turnarounds, the difficult issues don’t get easier to solve with time. People are expecting answers for those tough issues and can get distracted if they aren’t put on the table and resolved in a straightforward manner.

Tough issues aren’t always concrete issues. Sometimes the soft issues, such as the vision for the new combined entity or the cultural

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Human Capital and M&A

By Graham W. Galloway and Dale E. Jones

12 crucial people questions for directors



Graham W. Galloway



Dale E. Jones

During mergers and acquisitions, boards rightly focus on the strategic, financial and governance aspects of a transaction in order to further the goal of maximizing shareholder value. However, they often neglect one of the greatest sources of value in

many M&A transactions: the talent of the management team in the target company. In our experience, exercising due diligence about talent is as important as paying close

Why the neglect of people issues? During such combinations, boards largely rely on investment bankers, who are usually the chief advisors to the company about the pending transaction. Understandably, bankers focus on the financial aspects of the deal. Addressing the people issues comes much later in the process, if at all. Management, too, often underestimates the value that can easily be destroyed by some of the most common practices in post-M&A staffing.

For example, in straight acquisitions a winner-take-all mentality often prevails. Executives of the acquiring company simply keep most of the top jobs in the post-merger organization and little effort is made to retain the next tier of executives in the acquired company. Yet it is the talent of those executives that made the acquired company a desirable target in the first place. In service-based

Even in mergers where a genuine integration of the two companies is intended, the value of talent often gets less careful consideration than it should. For example, when one of the merging companies is larger than the other, the smaller may demand some key positions in the post-merger organization as part of the negotiation of the deal. Instead of genuinely assessing the talent of the two companies to make sure that positions are filled by the best available person, the parties simply divvy up the positions as part of the transaction agreement. In addition, the mid-level executives from the lesser partner who stay with the organization, knowing that no real assessment of talent has taken place, may doubt their chances of succeeding in the new company, become demotivated, and eventually leave.

There is a strategic promise behind every acquisition—and leadership

Even in mergers where a genuine integration of the two companies is intended, the value of talent often gets less careful consideration than it should.

attention to the balance sheet, cash flow and expected synergies of a deal. By asking management a series of questions about human capital in a merger or acquisition, boards can contribute to a smoother transition to a single company, a better merging of cultures, the loss of fewer “A” players, and a stronger talent bench for the merged company—all of which should ultimately create more value from the deal.

companies, certainly human capital delivers the value. But even in a less obvious example, such as a patent-based acquisition, much of the value in the acquired company has been created by people who contributed to the technology that leveraged the patent estate. In both cases, simply allowing that talent to walk out the door increases the likelihood that the acquirer will be getting a less valuable asset.

has to be able to deliver on that promise. Defining what kind of leadership is required and selecting and deploying those leaders in the right leadership teams is essential. While M&A transactions can vary greatly and some of the human capital considerations discussed here may not apply, in most cases there is a key question that boards should always ask: “What are we doing to determine our leadership requirements and to



gain the best essential talent from both companies?”

This is not to suggest that the board should encroach on the operating decisions of management. However, to help ensure that value isn't inadvertently lost or destroyed, we recommend that boards considering a deal dig deeper into the human capital issues by exploring some further questions and their implications, including:

1. What is the current talent situation in our company?

A thorough review of your company's talent bench and succession plans can establish a good context for people

decisions regarding the merger. For example, many companies have undertaken succession planning for key roles and identified “high potentials” in the company. Recent talent assessment work will also usually show gaps in the succession plan, which might be filled with talent from the acquired company.

2. What has the target company done in terms of its own talent assessment and succession planning?

The target company's talent assessment efforts should have identified high performers, high potentials, and potential successors in its organization. This information can be combined with the acquiring

company's assessment as a starting point for an objective look at the talent available in both companies.

3. What is the anticipated post-merger organization structure?

If the acquired company will operate as a standalone division, it may make sense to retain much of the senior management in the new organization. In a merger of equals in which most functions will be fully integrated, key choices must be made to define the new leadership structure, top team and operating model, and then ensure that the “best” and “best fitting” executive is appointed for each and deployed on the right leadership team.

4. What are the key roles that should be assessed in the context of the transaction?

This is, in essence, another way of getting at where the value of the deal will be found and where top talent will be most important for realizing that value. For example, when new technologies are acquired, it will be important to retain the staff that developed the technology. If key brands are acquired, retaining the marketing team may be an important source of value. If sales synergies are an expected source of value, then top sales positions will be critical. The same is true of relationship managers for key customers.

5. What is the process by which executives will be assessed—on both sides—to ensure that the “best” executive is appointed for each role?

The goal here is to make sure that the company avoids the waste of talent incurred in the winner-take-all approach, the negotiated approach, or simple seat-of-the-pants judgments by management. The board will want to have confidence that the process will,

in fact, focus on the value of talent, regardless of which organization it comes from.

6. Is the merger of leadership cultures important to the success of the transaction?

For example, the acquiring company may need the target company's help in entering unfamiliar markets or for a jolt of entrepreneurial energy, requiring the retention of key leaders who created the original culture at the target company. Similarly, retaining key leaders who embrace the integrated company and can serve as supporters and role models for their colleagues is important.

7. What kind of leadership team will the company require post transaction?

The level of integration required in most M&A situations today typically calls for highly participative teamwork, which can be a dramatic departure in style and substance for one or both predecessor companies.

8. Does our company have the resources, time, expertise and—perhaps most important—the objectivity to do a comprehensive talent assessment itself?

Management, in reviewing a few resumes and conducting some interviews with executives of the target company, may believe that an adequate assessment process is in place. But in reality, these half-hearted efforts often lack rigor and certainly lack objectivity. Moreover, most companies lack the personnel, the experience and the capabilities for undertaking large-scale talent assessments. Inevitably, the few resources that are available are often stretched thin and focused on other aspects of the transaction.

But the real question is not how much the process costs, but how much value is lost by not making a meaningful effort to leverage the best talent.

9. Will a “talent committee” be formed to specifically focus on the people aspect of the transaction?

Forming such a committee, with specific tasks and responsibilities, will provide the focus this process needs. The makeup of such a committee, including the degree of board involvement, if any, is important to ensure that optimal results emerge from the process.

10. What will the company do to “recruit” executives to join the merged company?

Having executives in the target company “apply” for senior positions in the merged organization flies in the face of experience. Senior executives typically don't apply, they must be recruited. Keeping the most talented people may require offering them retention packages as good as or better than their severance packages. In our experience, boards often have a difficult time accepting this idea, but again it's an issue of creating long-term value for the acquiring company. Similarly, retention efforts should be extended through the early post-merger integration period to make sure that high potentials don't leave during this often stressful transition period.

11. What is the communication plan around the executive assessment and selection process?

Candid communication about the process, including objectives, timing, process management, team membership and selection criteria provides an early opportunity to set

the right tone and to establish trust in the new organization. Ideally, the process itself, by virtue of being objective, transparent and merit-based, will further establish trust. In our experience, an objective and comprehensive process leads to higher retention. Key executives appreciate the effort and professional courtesy and often decide to make a renewed commitment to the new company.

12. What processes are in place to ensure the effective integration of those selected into one cohesive top team and leadership structure?

Successful post-merger integration of leadership talent sets the tone for longer-term success. New team start-up, new leadership operating styles and new decision-making structures require attention and support but are often neglected.

These questions, or questions like them, can help boards satisfy themselves that management has an adequate plan in place to extract the full value of the human capital in the deal. Often, companies that have a record of successful M&A activity already have a proven process in place. Companies that lack such a process can create one, assuming they have the resources and the expertise to do so, or they can retain an independent advisor with expertise and experience in conducting an objective assessment process rapidly and rigorously. Given the potential value at stake, the selection of such advisors on the human capital side is as important as the selection of the

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Independence and Boutique Investment Banks

By Frederick C. Lane

Advice is indisputably independent only when it is unaffected by other economic considerations.



Frederick C. Lane

Boards of directors and special committees of boards are increasingly aware of the importance of seeking the advice of

independent financial advisors. Just as boards and special committees frequently require legal counsel separate from the company's counsel, an independent investment banking firm can be important to the board's ability to evaluate

seller's investment bank. Does the investment bank prefer certain buyers paving the way for future business? Is the firm participating directly or indirectly in financing fees related to the potential buyer's acquisition? And, in light of the magnitude of the contingent fees, is the fairness opinion being provided to the board truly based on an independent and objective appraisal?

In response to concerns about independence, boards are increasingly demanding the involvement of a co-advisor, solely to ensure an independent fairness

not compete against their clients in any of their businesses. No less an authority on the investment banking industry than Goldman Sachs stated in a 2006 research report that boutique firms would likely increase their share of the global market for merger and acquisition advisory fees from less than 10% today to more than 25%, due to "the inherent conflicts in lending and underwriting relationships."

Independent investment banking firms are engaged for reasons beyond their independence and objectivity. These reasons fall into

Make sure you know the specific make-up and experience of the day-to-day team who will be advising you and how they will be allocating various tasks.

comprehensively the merits and drawbacks of a potential transaction versus alternatives and thus fulfill their fiduciary responsibilities.

Why is independence in an investment banking advisor important? The most obvious reason is that advice is indisputably independent only when it is unaffected by other economic considerations. A significant sale transaction generally entails the payment of a substantial contingent fee to the investment bank representing the seller plus a smaller, separate fee for a fairness opinion. Not so obvious are other and potentially larger economic benefits which may accrue to the

opinion, where the only fee to be paid to the co-advisor relates to the fairness opinion, and there is no contingent consideration.

The Role of Independent Investment Banking Boutiques

"Boutique" investment banks have jumped into the void for independent, conflict-free advice. Their value proposition is first and foremost that their only clients are managements, boards, and special committees of boards. These firms do not serve institutional investors through sales, research or trading nor do they act as principal investors in leading leveraged buyout transactions. Put differently, they do

three principal categories: the seniority and sophistication of staff; specialized industry knowledge; and specialized transactional experience and expertise.

Senior, Experienced Engagement Leadership

For the largest investment banks, advisory fees are a small sliver of total revenues, generally far less than 10%. The fees from financing activities far outstrip pure advisory fees. (And all investment banking revenues are generally less than 20% of total firm revenues, with principal activities, primarily proprietary trading, accounting for the majority of revenues.)

Boards and special committees must ensure that they have in place financial advisors whose incentives and interests guarantee objectivity and independence.

Accordingly, these firms do not dedicate their most senior, most experienced talent to their M&A and corporate finance advisory practice. Instead, they “push down” day-to-day responsibility on purely advisory engagements to professionals with 5 or fewer years in the business. By contrast, the sole business of investment banking boutiques is sophisticated advice delivered by highly experienced, senior partners.

My advice to boards and special committees: make sure you know the specific make-up and experience of the day-to-day team who will be advising you and how they will be allocating various tasks. When will the lead banker be present? How much authority and responsibility will be delegated to junior staff? Don't assume anything. Ask.

Industry Expertise

A second consideration in engaging an independent investment banking firm is the specialized industry knowledge such a firm can bring to the table on behalf of the board or the special committee. Highly focused knowledge of the dynamics of an industry sector, the active acquirers in that sector, the valuation metrics of deals in the space, relationships with key players—all are important to a board or special committee evaluating a specific transaction or alternatives

to that transaction. If the primary financial advisor to the board lacks industry knowledge, bring on a co-advisor who has that knowledge.

Specialized Relevant Deal Experience

A third critical objective in engaging a financial advisor is often to obtain specialized transactional experience, relating to for example, proxy contents, takeover defense, or going-private transactions, to name a few. While all of the large firms have experience in these sensitive deals areas, make sure that the lead engagement partner of your team possesses the necessary deal experience and technical knowledge.

With All That Knowledge, Why Can't We Access It?

The irony in the evolution of the investment banking industry is that while the largest firms have impressive knowledge and sophistication across virtually every aspect of a potential transaction, harnessing that knowledge on behalf of a client in a given situation is difficult. Once a client determines a course of action, say the initial public offering of a subsidiary, and hires a group of bulge-bracket firms to manage the offering, evaluating alternatives, such as an outright sale or purchase of a significant equity stake by a consortium of private equity firms, becomes difficult. The

equity capital markets teams of the underwriting group have little M&A or private equity financing expertise, so evaluating alternatives is cumbersome at best and frequently dismissed without appropriate analysis and consideration.

An independent investment bank can help select the right lead manager for a public offering, and if a change in strategic direction is required, can be there to help evaluate how best to execute the alternative transaction. The independent investment bank's economic incentives are not biased as to which transaction to execute, ensuring their independence and objectivity.

Boards and special committees must ensure that they have in place financial advisors whose incentives and interests guarantee objectivity and independence. Boards should supplement their advisory team with co-advisors who bring to the table critical complementary experience and knowledge.

Boards need to be sophisticated purchasers of investment banking services and should exercise their right to select the team of financial advisors who best meet their specific needs.

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“Boutique” investment banks have jumped into the void for independent, conflict-free advice.

What Directors Need to Know About Fairness Opinions

By Jeffrey Williams

Traditional fairness opinions are coming under increasing scrutiny from a number of sources



Jeffrey Williams

Board members must understand the potential conflicts that are inherent in transaction advisors also providing a fairness opinion.

For over 20 years, boards have relied on traditional fairness opinions to protect their members against shareholder lawsuits. This practice sprang to prominence following a 1985 Delaware Supreme Court decision in *Smith v. Van Gorkum*. In that particular case, the directors of the acquired company were found personally liable collectively for \$25 million for breaching their duty of care in the sale of the business. The judge noted the board's failure to obtain a fairness opinion was one of the flaws in the sales process. Since then, fairness opinions have been a functional requirement in corporate change of control transactions. Typically they have been provided to the board by the company's transaction advisor in addition to their other roles in the deal.

But the landscape for fairness opinions is evolving rapidly. No longer are traditional fairness opinions—those provided by transaction advisors—accepted without question, and consequently they no longer provide the same level of legal protection.

Traditional fairness opinions are coming under increasing scrutiny from a number of sources for the conflicts naturally inherent opinions provided by transaction advisors:

Courts. Delaware courts, which historically have been deferential to the judgment of boards, are taking a more critical look at director conduct, including the fairness opinions on which they rely. Two recent opinions shed some light on their emerging views on how potential conflicts impact fairness opinions. In the *In Re Toys "R" Us, Inc.* opinion, the court acknowledged the conflict inherent in the advisor to the seller providing a fairness opinion as well as stapled financing to the buyer. Practitioners have quickly interpreted this as an indication of the court's position on advisory conflicts and have begun to advise their clients to rethink their fairness opinion policies. On a more general note, in *In Re Tele-Communications Inc.*, the court provided clear insight into its view that a contingent success fee arrangement is a conflict for a transaction advisor who also provides a fairness opinion.

Investors. Some large and influential investors have been quite explicit about their objections to transaction advisors also providing fairness opinions. As an example, the California Public Employees' Retirement System (CalPERS), which has over \$180 billion in assets, recently stated that "[the NASD] should prohibit investment banks from receiving 'success fees' for

transactions in which they issue fairness opinions."

Regulators. In line with Sarbanes-Oxley, the NASD has been looking into the growing concerns with fairness opinions. It has proposed Rule 2290, a disclosure based approach to highlighting conflicts in fairness opinions, which is currently in its fourth amendment. Importantly, while disclosure will highlight the concerns, it does not, by itself, resolve the issues. A conflicted opinion, in spite of disclosure, is still not suitable to be relied upon.

Shareholder activists are also increasingly taking prominent roles in M&A transactions, challenging the values agreed upon and, implicitly or explicitly, the fairness opinions. One recent, notable example was the Apax Partners acquisition of Tommy Hilfiger. Sowood Capital Management, an activist hedge fund which owned 6.3% of Hilfiger, launched an attack on JP Morgan in an effort to block the transaction. In its letter to the Hilfiger board, it encouraged the board "to reconsider the auction process given the inadequacy of JP Morgan's fairness opinion..." While the transaction ended up closing, activist investors can exert extreme pressure on the board in the midst of a corporate transaction. And we are seeing this type of activity more and more frequently.



Recent legal rulings provide a strong indication of Delaware's developing view that a transaction advisor is hard pressed to offer an impartial fairness opinion.

What Can Directors Do?

In order to effectively protect themselves, board members must first understand the potential conflicts that are inherent in transaction advisors also providing a fairness opinion. The more common categories of conflicts include:

Contingent fees. Fairness opinions traditionally are provided by transaction advisors who are compensated through a “success fee” that is paid only upon completion of the deal. Thus, bankers have an incentive to call a deal “fair” because their compensation hinges on the transaction closing

Future business. Investment bankers are motivated by opportunities to provide transaction advisory services and view fairness opinions as a

chance to build relationships with the management and company. They are thus incentivized to support a deal in hopes of securing lucrative future work.

Dual representation. The most obvious form of this is representing both buyer and seller. Less obvious, but equally troublesome, is the increasingly prevalent role of “stapled financing” in which the transaction advisor to the seller also provides financing to the buyer.

Then, directors must take action to insure they are informed and protected by separating the roles of transaction advisor and fairness opinion provider in situations in which there are potential conflicts. Not only is this practice supported by institutional investors and the courts, but the trend towards distinct providers is growing.

This is evidenced by numerous examples of boards securing an independent fairness opinion from a provider with no ties to the deal or the parties to the deal. Recent high profile examples include the respective sales of May Department Stores (\$18.4 billion), Albertson's (\$17.4 billion), Constellation Energy (\$16.6 billion), Sungard Data Systems (\$11.5 billion), Dex Media (\$9.7 billion) and Texas Instruments' sensors and controls business (\$3.0 billion).

Recent legal rulings provide a strong indication of Delaware's developing view that a transaction advisor is hard pressed to offer an impartial fairness opinion. Specifically, the Court, as well as investors, regulators and the media, are looking far more critically at conflicts that can impair an advisor's independence. In light of this, board members should consider independent fairness opinions to insure legal protection and unbiased views on value.

Jeffrey Williams is president of Jeffrey Williams & Co., an independent valuation services firm providing transaction fairness reviews, valuation mediation, private company valuation and dispute resolution services. Immediately prior to founding his firm, Williams was a partner at Greenhill & Co. where he advised clients in the Media, Technology and Telecommunications industries, including Compaq Computer Corporation and Chancellor Media Corporation. Previously, Williams had a 17-year career at Morgan Stanley & Co. in the Mergers and Acquisitions and Corporate Finance Departments. He served as the head of the company's Telecommunications and Media Group for 12 years, acting as principal financial advisor on transactions valued in excess of \$200 billion.

He earned his M.B.A. from Harvard Business School (with distinction) in 1979. He currently serves as a trustee and co-chairman of the University of Cincinnati Foundation, trustee of the New York-based International Center of Photography and member of the President's Council at Environmental Defense. For more information on the firm, please visit www.williamsnyc.com.

What's the Value of a Fairness Opinion?

By Jill R. Goodman

Business judgment encompasses more than relying on an expert's view that the consideration in a transaction is fair.



Jill R. Goodman

Fairness opinions—and more specifically, the potential or actual conflicts of interest of the financial advisors providing

the fairness opinions—have been the subject of much debate, particularly over the past year. A number of important decisions from the Delaware courts, combined with strong interest on the topic from the NASD and the SEC, have driven the discussion. As corporate

the implications of conflicts and not simply be confined to opinions? It seems to be only a matter of time before bad facts come to light, causing directors to focus more intently on the topic.

While not necessary, neither is a fairness opinion sufficient. Directors cannot demonstrate they have exercised their duty of care in approving a business combination solely by reference to a fairness opinion. Business judgment, afforded much deference by courts, encompasses more than relying on an expert's view that the consideration in a transaction

transaction is within the reference range of values. The opinion does not address strategic, operational, management, timing or legal considerations. The opinion does not address whether the proposed consideration is the best result attainable under the circumstances. To the dismay of some commentators, the opinion does not make any qualitative judgments on the company's financial projections, although separately bankers do often comment on the assumptions underlying projections. Importantly, a fairness opinion does not answer the "should" question—should a director vote for or against a particular deal.

Directors cannot demonstrate they have exercised their duty of care in approving a business combination solely by reference to a fairness opinion.

overseers who owe fiduciary duties to shareholders, corporate directors are directly affected by this controversy. The exercise of a director's fiduciary duties, especially in the context of an M&A transaction, can be subject to intense scrutiny—from shareholders, from the press and from courts. In focusing on conflicts of interest only as they impact fairness opinions, the debate misses the mark. The implications of conflicts, and the issues upon which directors should be focused are fundamental, extending well beyond the pages of fairness opinions. Will the debate move to a broader discussion about

is fair. Directors have the benefit, and the corresponding obligation, of considering and weighing the totality of information available to them to make decisions.

The Narrow Question

A fairness opinion answers a narrow question. With a given set of inputs in the form of management's projections, the bankers perform a series of valuation exercises and determine a reference range. The fairness opinion is a determination that, at a particular point in time, the proposed consideration in an M&A

Although a fairness opinion only addresses whether or not the consideration to be received is "good enough," directors are not left without professional financial advice. A fairness opinion is typically only one aspect of a much broader role. Bankers provide financial advice through the duration of the deal, from the initial due diligence review to the final stages of the negotiation. The bankers' input is a critical component of how directors exercise their business judgment. Together with the directors' knowledge of the company, industry, management, economic climate, etc., the directors rely on the company's advisors for a host of deal-related issues, including negotiating tactics, strategic alternatives and financial implications. It is in this context that potential conflicts of interest should

be of most concern. Directors are relying on the professional judgment of their bankers (and attorneys and accountants) regarding the infinite shades of gray that comprise a deal, not just the narrow question addressed by a fairness opinion.

Conflicts of Interest

The tension created by a conflict should be addressed when the conflict or potential for conflict becomes apparent, not shelved until the time the need for a fairness opinion is considered. The most obvious example of the wisdom of this point of view is Delaware's well-developed case law on special committees. A special committee that is properly constituted and functioning creates certain benefits for directors under Delaware law. A critical element of being properly constituted is engaging separate, unconflicted advisors at the start of the process, not waiting until the opinion stage. Similarly, a conflict of interest affecting a company's financial advisor should be addressed and appropriately remedied as soon as it becomes apparent.

Conflicts of interest take many forms. Conflicts affecting financial advisors are sometimes obvious and sometimes not, but the manifestations of conflicts are not usually transparent. In a sale process, the seller's financial advisor may be conflicted because it is representing a potential buyer in an unrelated buy-side transaction. Or a financial advisor may have a conflict because it runs a private equity fund that is likely to be a bidder in the sale process. Or the financial advisor may intend to provide financing for the potential transaction, either at the outset to all of the bidders or to the winning bidder after a transaction has been negotiated.

Take the example of financing provided by the seller's advisor and consider how it may affect the advisor throughout the sale process, not just at the opinion stage. From the outset, the advisor stands to collect financing fees on the buy-side that far outweigh the success fee on the sell-side. When the auction process begins, the advisor may—even unwittingly—favor bidders that commit to use the financing; potential buyers that have alternate, lower cost sources of debt (particularly financial buyers that have existing financing relationships) may adjust their equity pricing downward accordingly. Also, there exists the risk that some financial buyers, because they do

not want to use the financing, may perceive themselves at a competitive disadvantage and decline to participate in the process. Regardless of what the opinion will eventually say, it will never give assurances about the purity of the process. An “honest auctioneer” is the best approach for a pure process.

The conflict does not ease as the sale process progresses. The seller will narrow the field of bidders by favoring those who offer a high price and deal certainty. The seller's banker, however, as lender to the buyer, will favor bidders whose pricing is most reasonable in terms of leverage and who maintain some optionality on closing if circumstances change. Of course, the directions to bidders and the

distinctions between bids will be subtle and the manifestations of the conflict will be opaque. Even after a deal has been negotiated, the conflict persists. What if a deal has been signed and circumstances do change, requiring renegotiation? Or an interloper appears? How can the banker act on behalf of the seller and not impair its own position as lender?

Directors should not exercise their business judgment based solely on the advice of a conflicted financial advisor. The easiest remedy is to use an advisor with few if any conflicts, but this may for sound reasons not be feasible or desirable. If a conflict exists, rather than try to exercise their business judgment around the nuances of the

The fairness opinion is a determination that, at a particular point in time, the proposed consideration in an M&A transaction is within the reference range of values.

potential taint, directors should engage a separate advisor for an independent point of view as soon as the potential conflict becomes manifest. Waiting until the opinion stage does not serve the best interests of the directors or the shareholders for whom they are acting. Whether it takes a Delaware judge or a few high profile boards to reach this conclusion first remains to be seen.

Jill Goodman is a director in the Banking Group at Lazard focusing on mergers and acquisitions. She has a particular focus on both complex M&A transactions involving conflicts of interest at the board level and corporate governance matters. She has acted as advisor to numerous special committees and independent committees of boards of directors, as well as to controlling shareholders. The views expressed in this article are those of Ms. Goodman and do not necessarily reflect the views of Lazard.

Second Opinion on Fairness Opinions

By Bruce Bingham

Opinions of value can provide the board with another level of M&A due diligence



Bruce Bingham

A fairness opinion prepared by a party fully independent to the transaction should leave no doubt that a director has covered all

professional and legal bases. But in today's environment, how safe is safe?

In order to prove that a director has met his or her obligations under the business judgment rule in today's expanded litigious environment, that director must be adequately informed before making any decisions. Because of the increased scrutiny given to fairness opinion independence, more and more directors and their legal

Opinion of Value

What is the difference between a fairness opinion and an opinion of value? While the analytical processes are quite similar, the big difference is that an opinion of value does not include an assessment on the part of the valuator as to whether or not a transaction is fair to a party to a transaction. As such, an opinion of value leaves the determination of fairness solely to the directors and, therefore, provides less protection to the board.

Next, a valuation firm will typically apply approaches to value and professional valuation standards that are mandated by the Uniform Standards of Professional Appraisal Practice (USPAP). This set of standards

business are the market approach, the income approach, and the cost approach; all of which use different sources of quantitative data that result in indications of value.

The cost approach considers the net asset value, and is relevant primarily to holding companies and asset intensive businesses. The market approach is an *ex ante* valuation looking back at publicly available historical data of comparable companies to correlate performance into indications of value. The income approach is forward looking, using company prospective financial information to get to a net present value indication. The results of the individual approaches are then reconciled into the opinion of value. Many investment banks

Increasingly, boards are seeking a higher level of due diligence, thus soliciting the help of independent valuation firms to perform either a second, parallel fairness opinion or prepare a business valuation opinion for the private use of the board.

counsel are concerned that the legal requirement of being adequately informed should not rely simply on having a fairness opinion, but in making sure that its creation was truly independent of any financial beneficiaries to the transaction.

Increasingly, boards are seeking a higher level of due diligence, thus soliciting the help of independent valuation firms to perform either a second, parallel fairness opinion or prepare a business valuation opinion for the private use of the board.

is promulgated by The Appraisal Foundation's Appraisal Standards Board, founded in 1987 as one of the Federal government's responses to the savings and loan crisis.

USPAP mandates consideration of each of three traditional approaches to value, and, if information exists with which to apply an approach, that approach must be utilized unless clearly not applicable. The three methods commonly used to arrive at an objective opinion of value for the acquisition or sale of a

use aspects of these approaches such as a discounted cash flow or performance multiples (price to earnings, etc.), but they may not go through each approach in its entirety, thereby possibly missing a key piece of the analysis.

Analytical Comfort

The analytical capabilities of valuers may also be of valuable service to a board. A major source of comfort in bringing in

(continued on page 49)



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The Directors & Boards Survey: Mergers & Acquisitions

Methodology

This **Directors & Boards** survey was conducted in July 2006 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 406 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	34.5%
A director of a non-profit entity	26.1%
A senior level executive (CEO, CFO, CxO) of a privately held company	21.7%
Other shareholder	17.2%
Attorney	16.7%
Auditor, consultant, board advisor	13.8%
A senior level executive (CEO, CFO, CxO) of a publicly held company	11.3%
Academic	5.9%
Institutional shareholder	5.4%
An investor relations professional/officer	3.9%
Other	6.3%

(Other responses included: retired director, consultant, D&O underwriter, corporate secretary, internal M&A executive.)

Revenues

(For the primary company of the respondent)

Average revenues:	\$1.965 billion
Less than \$250 million	51%
\$251 million-\$500 million	7.1%
\$501 million to \$999 million	15.3%
\$1 billion to \$10 billion	17.9%
More than \$10 billion	8.7%

Board Service

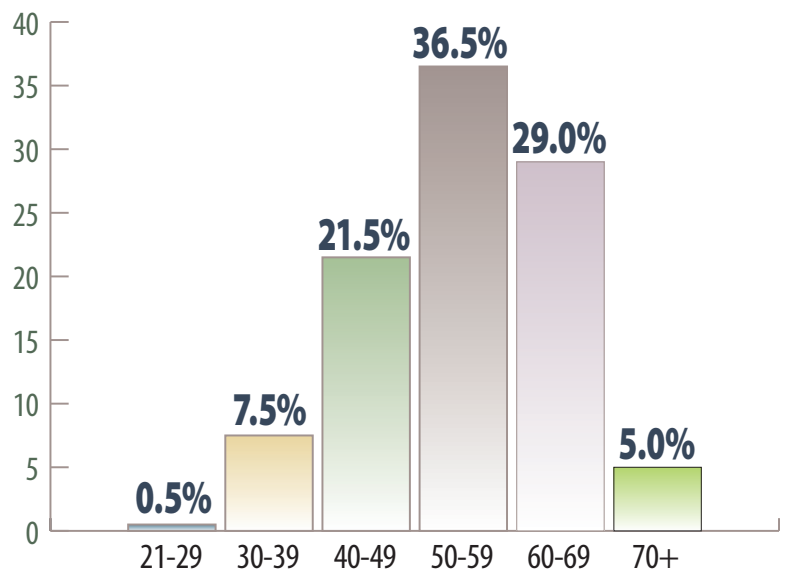
(Average number of boards respondents serve)

Public	1.20
Private	1.42
Charitable	1.88

Respondents' Age

Average Age:

55



Directors' 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)	39.2%
Yes, we sold a company(ies) or business unit(s)	16.9%
Yes, but we did not make a purchase or sale	16.9%
No	38.6%
Other	2.4%

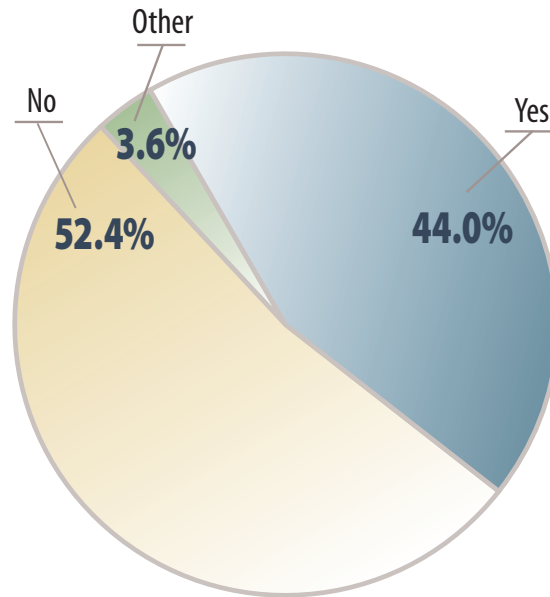
(Other answers included: Advised or assisted companies in M&A transactions.)

If yes, what was the approximate aggregate deal value of these purchases/sales?

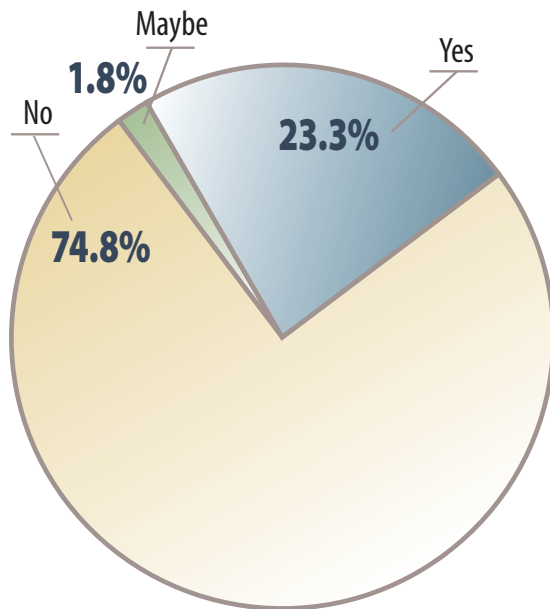
\$134,888,820.05

Does your primary company plan to purchase a company or line of business in the coming year?

(Other answers included: “Not actively pursuing, but would consider a ‘good fit’ opportunity.” “Potentially, if the opportunity presents itself.”)



Does your primary company plan to sell a company or line of business in the coming year?



In your experience, has your company/board ever:

(Multiple responses allowed)

Paid more than an acquisition was worth?	50.4%
Paid less than an acquisition was worth?	47.8%
Seriously misjudged the cultural or operational fit of an acquisition?	39.1%
Acquired a company or business unit that fundamentally changed the nature of your company's core business?	23.5%
Bought a company to force a change in your company's strategy?	11.3%
Acquired assets for short-term improvement of financials?	9.6%
Other	20%

(Other answers included: “Not applicable.” “No M&A activity.” “Our board includes an expert on acquisitions. If we acquired something wrongly, we couldn't admit it. This is a serious answer.”)

In the coming year, in which of the following regions do you anticipate purchases or sales of assets?

(Multiple responses allowed)

North America	64.2%
Europe	22.6%
China	9.4%
Asia	8.8%
South America	5%
India	4.4%
Middle East	3.1%
Africa	1.9%
Not Applicable	27%
Other	2.5%

(Other answers included: Australia/ New Zealand, Central America)

What is the single primary reason driving M&A activity at your primary company?

Strategic fit	49.4%
Increase in revenues	12.3%
Expansion into new markets	12.3%
No real strategy	9.7%
Operational synergies	8.4%
Cultural synergy	0.6%
Low interest rates	0%
Add new leadership talent	0%
Other	7.1%

(Other answers included: “Private equity firm exit.” “Liquidity for investors.” “New strategic direction.” “No M&A activity at present.”)

Has your primary company ever sought to remedy common corporate ills through merger or acquisition, including:

(Multiple responses allowed)

Limited product/service offerings	23.9%
Underperforming financial results	16.2%
Succession/leadership issues	12.7%
Over-competition in your market(s)	11.3%
High corporate overheads	9.2%
High taxes	0%
None of these	57.7%
Other	3.5%

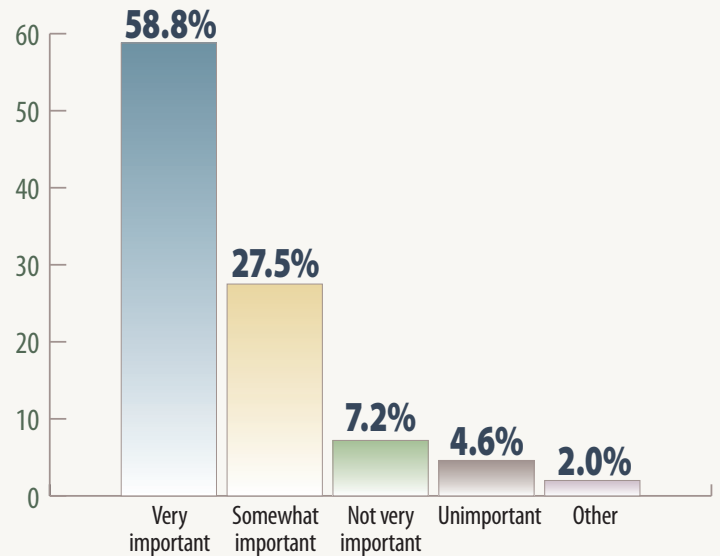
(Other answers included: "Not applicable." "Made purchase to fix our company." "Acquired better brand recognition of partner." "Acquired to address technology shifts in our market.")

The Mergers & Acquisitions Environment

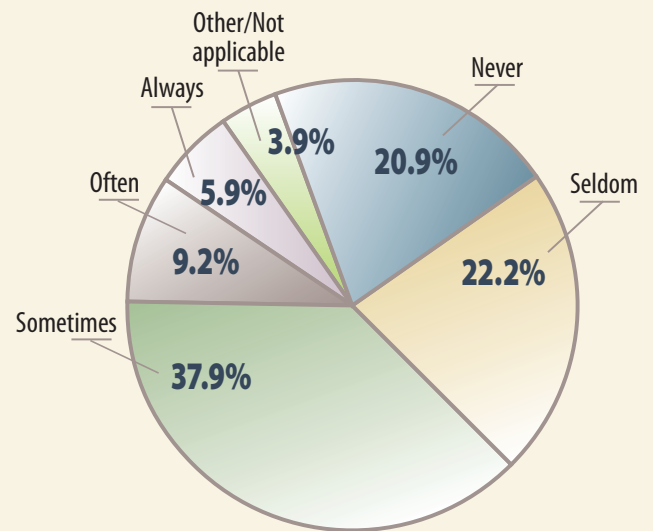
Compared to 2005, please predict how M&A transactions will look in your primary company's industry by the end of 2006?

There will be significantly more M&A transactions	16.2%
There will be slightly more M&A transactions	31.8%
There will be about the same M&A transactions	35.1%
There will be slightly less M&A transactions	12.2%
There will be significantly fewer transactions	2.7%
Other/Not Applicable	2%

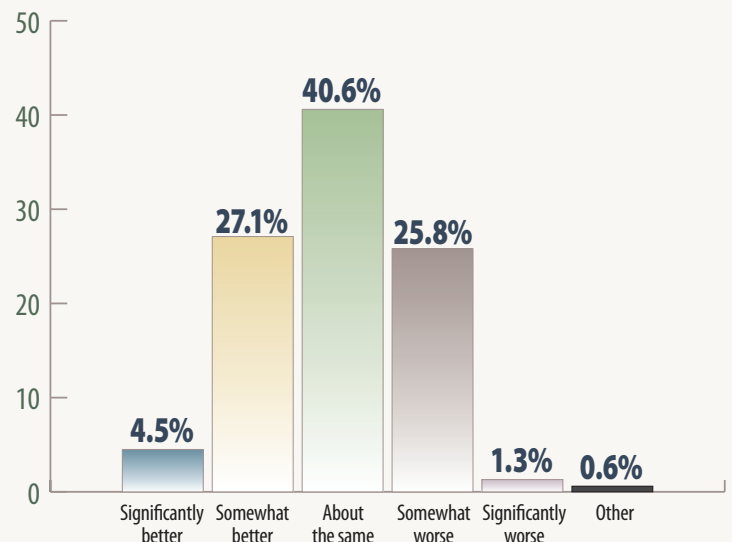
How important is "cultural synergy" in your primary company's M&A strategy?



Do you consider forming strategic alliances with potential acquisition targets prior to merger to "test drive" the prospects for a successful union?



By the end of 2006, how will the economy look compared to 2005?



Have you found the impact of activist shareholders on the M&A process to be:

Increasing, seriously jeopardizing the deal process	6.1%
Increasing, with impact more or less contained within the corporation and dealt with internally	29.1%
About the same	23%
Decreasing	0%
Not a factor	37.2%
Other	4.7%

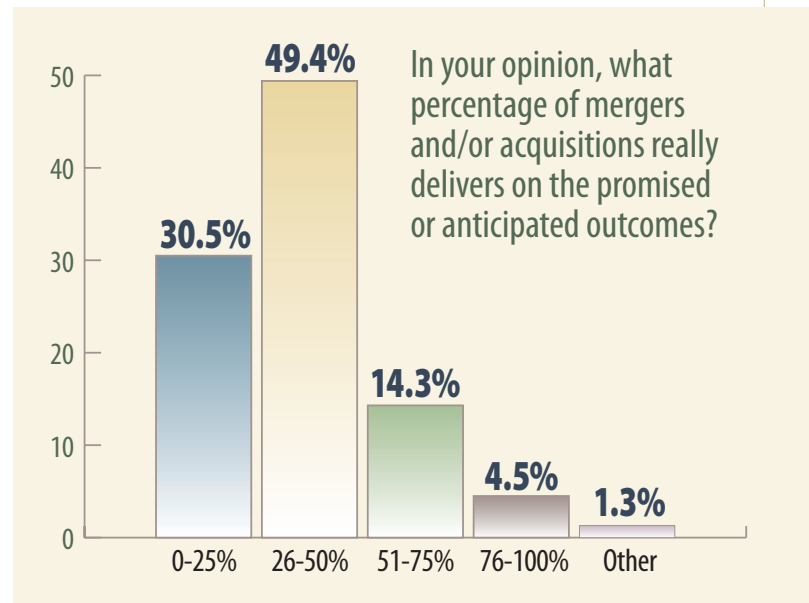
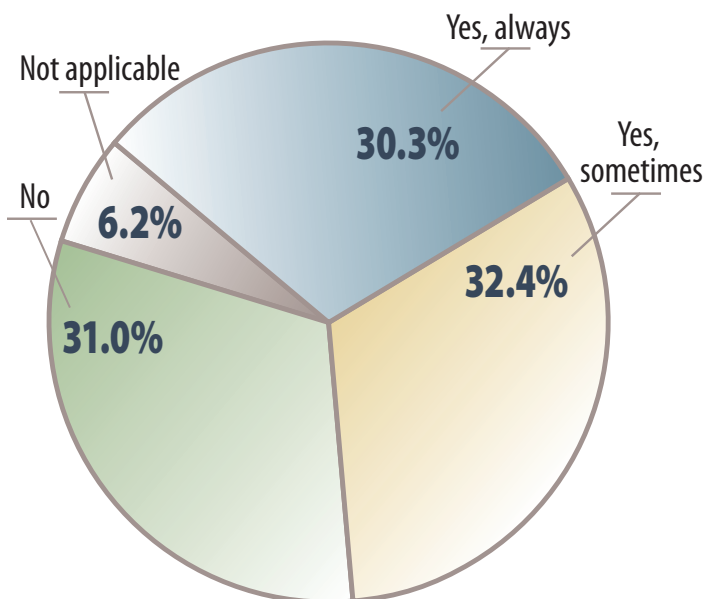
(Other answers included: "Impact is increasing, and raising the pressure to do M&A.")

How has the regulatory environment over the past three years affected your company's M&A activity?

Sharply increased the impetus for M&A	4.7%
Slightly increased the impetus for M&A	13.5%
Has had no impact on M&A	65.5%
Slightly decreased the impetus for M&A	12.8%
Sharply decreased the impetus for M&A	1.4%
Other/Not Applicable	2%

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?

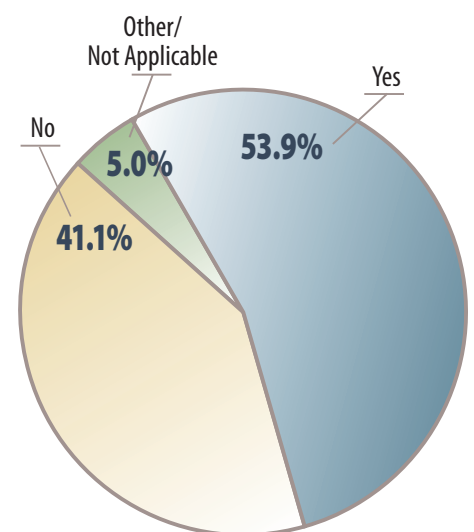
(Multiple responses allowed)

Management's law firm	57.6%
Management's accounting firm	55.4%
Management's M&A firm	48.2%
Independent consultants from related industries	39.6%
Board's law firm	30.9%
Board's M&A firm	26.6%
Board's accounting firm	26.6%
Other/Not Applicable	8.6%

(Other answers included: "We ask experienced CEOs not on our board." "High reliance on internal tax and financial resources." "External communications firms.")

Has your board ever voted down or materially changed a contemplated acquisition or sale?

(Other answers included: "Substantial input and guidance, but no veto yet." "Changed the sale approach prior to final vote.")



If yes, why?

(Multiple responses allowed)

Misalignment with our strategy	36.8%
Business conditions	36.8%
The health and/or prospects of the acquired company were misrepresented	20.7%
Economic conditions	16.1%
Not applicable	12.6%
Shareholder resistance	11.5%
Material disclosures were omitted	10.3%
Other	13.8%

(Other answers included: “We were acting stupidly.” “Inadequate offers; lacked confidence would close.” “Seller continued to want to negotiate the terms for an unreasonable period of time.” “Board felt company overestimated value of acquisition.” “Stock price movements.” “Management was split on doing the deal.” “Price grew too high.”)

Ultimately, where does the credit/blame reside for the outcomes of a merger or acquisition?

With the board	32%
With management	59.9%
With line of business executives	2.7%
With inside M&A experts	0.7%
With outside consultants	0%
Other	4.8%

(Other answers included: “Depends entirely on the situation. Mostly, there’s blame to go around for all.” “Whoever is most responsible for integration.” “With the board AND management.” “With either management or the board, depends on the size of the transaction.”)

Director Feedback

Thinking over the past five years, has your board’s role in your primary company’s M&A activities changed?

Ed Birch—*Chairman of the Board, Pacific Capital Bancorp*

“Our board is significantly more involved today in M&A activities than five years ago. Our acquisitions have, if anything, proved to be better for our company than earlier anticipated. An M&A specific consultant is working directly with the board in evaluating M&A opportunities. An M&A committee consisting of the board and senior leadership works together on evaluating all M&A opportunities. Our board meeting agenda has a line item “M&A opportunities,” which forces discussion of this matter at each board meeting.

Charles K. Oppenheimer—*President & CEO, Amvest Financial Group, Inc.*

Our board is totally behind our M&A activity. Generally, one of our board members will receive weekly briefings and that board member sends a weekly report to the other board members. The board will have frequent phone calls with management and will meet as is needed.

I believe that too often management gets too involved in M&A activity, which can take focus away from the operating business. We like to have a specific M&A person who focuses on this, as well as a designated board member, with management involved in the M&A process as needed instead of spending all their time on the acquisition. A good example of this is a private equity group which buys a company in concert with management. Management then proceeds to look for acquisitions and the operations suffer. I like to minimize the diversion.

Dave Guenthner—*President, BSM Executive Advisor*

The board’s role has shifted from passive review and approval of recommendations from management and hired “experts” to one of proactive involvement in the entire M&A process—strategy development through integration. Boards are now asking and demanding answers to the tough questions that result in successful M&A activities:

- 1) Why is the company really interested in a transaction with us? Companies willing to be acquired are willing for a reason—generally not because they feel they have the best strategy, management, products, execution or prospects on their own.
- 2) What happens to the target and what happens to us if we don’t do this transaction? If the answer isn’t compelling in terms of the business long term, ignoring the stock price, the deal probably isn’t worth doing.
- 3) What is the real culture of the target and does it fit with our culture and values? The stories that employees and other stakeholders tell about the target will disclose culture and values, not printed words or management-speak.
- 4) What will cause this merger to fail and how do we minimize the likelihood of those things happening? Protect the downside and the upside will take care of itself.
- 5) What’s this deal worth to us? What will we give up in terms of price, board seats, ownership concentration, strategy, management, people, culture and values to get this deal done? Know the answer before the process starts, don’t wait until you are caught up in the heat of the deal.
- 6) What are the measures and time frames that will indicate success during the integration of the transaction? The board must know and see the measures, monitor the progress and demand answers early and often during integration. Don’t wait until the end to see if you have been successful.

2006 M&A Outlook: Continued Strength

By Greg Falk and Malcolm Wright

The number of M&A deals will increase over the next year.

We include this study by KPMG as an additional survey resource to our own research, which is presented beginning on page 30.



Greg Falk

Over the past few years, the number of worldwide mergers and acquisitions has been trending upward as acquisitive companies have increasingly taken advantage of lower interest rates, enhanced competitive positioning, and the



Malcolm Wright

immediate impact of greater scale that a merger or acquisition can bring.

After surging more than 20 percent in 2004, the number of M&A deals worldwide flattened out to about 23,000 last year. But the M&A market appears to be going strong. The number of deals announced through the first two quarters of this year suggests an estimated 25,000 deals in 2006.

To examine this trend, KPMG conducted a survey this spring of 138 tax and M&A professionals regarding a number of key factors,

such as M&A market projections, activities, trends, roles, and responsibilities; tax-specific issues related to M&A; and business divestiture activities. The results suggest that both tax and M&A professionals believe the market is strong and tends to favor those companies that do their due diligence, extend to deals beyond their borders, and take into account tax issues when evaluating and driving new transactions.

The Upward Trend Will Continue

The results of the survey indicate that the number of M&A deals will continue to increase over the next year, with 6 out of 10 survey respondents estimating there will be more than 25,000 M&A deals worldwide this year alone. About 75 percent of those respondents place the value of all deals at greater than \$2 trillion.

Respondents predict the top three industries for M&A activity as telecommunications (44 percent), banking (30 percent), and energy (24 percent), closely followed by healthcare (23 percent), pharmaceuticals (22 percent), electronics (17 percent), consumer

products (16 percent), and software (16 percent).

In addition, 88 percent of those polled expect to complete one merger or acquisition this year, and more than 40 percent say their organizations have plans to sell, spin off, or divest a portion of their businesses over the next 18 months.

Companies Believe M&A Activity Improves Market Perception

Both tax and M&A professionals agree that the top factor leading companies to merge or acquire is “general business profitability,” with stock prices and regulatory and legislative activity following behind. In addition, two thirds of the respondents say that high acquisition activity positively impacts a company’s market perception.

In addition, the survey highlights enhanced competitive positioning as the primary objective of the respondents’ recent M&A transactions (76 percent), followed by access to new customers and segments (72 percent), increased scale (66 percent), and access to new product markets (61 percent.)

(continued on page 48)

Two thirds of the respondents say that high acquisition activity positively impacts a company’s market perception.

Preventing Executive Compensation from Derailing M&A Deals

By Ken Raskin and John Reiss

How to avoid common compensation pitfalls.



Ken Raskin



John Reiss

As every director knows—particularly with employee stock option backdating dominating the recent news—claims of excessive executive compensation often serve as a lightning rod for general criticism of corporations and their boards. In a merger

or acquisition transaction, the consequences of these allegations can be even more immediate and acute.

These days, if a board is perceived as approving overly opaque disclosures of compensation packages or “unreasonable” rewards to executives in M&A transactions, the fallout can include negative publicity, regulatory investigations, shareholder unrest and even scuttling of what would otherwise be excellent transactions. This can delay or obstruct crucial business growth plans.

M&A activity soared to recent record levels in 2005, and US and multinational companies continued to pursue M&A transactions at a very brisk pace throughout 2006. At the same time, shareholders, government regulators and the media have

focused increasing attention on executive compensation, including compensation packages related to M&A transactions. Powerful institutional investors such as pension plans, mutual funds and hedge funds

on allegations that they backdated stock options to increase executives’ pay illegally. The SEC, IRS and US Department of Justice have recently established task forces to review whether companies backdated

Before pursuing M&A transactions, directors should work with legal counsel to make sure all of their corporation’s previous option grants have been dated, disclosed and accounted for properly.

have withheld proxy votes to force changes in certain M&A transactions due to concerns over excessive compensation. Government regulators also entered the fray, with proposals for new compensation disclosure rules and corporate investigations.

If your organization plans to participate in a major transaction—whether as a buyer or seller—basic precautions can help you steer clear of some common pitfalls.

The Latest Hot Topic: Stock Option Backdating

Stock option “backdating” cases form the latest series of high-profile executive compensation scandals to hit the corporate world. Backdating occurs when a company sets employee stock option exercise prices as of a date prior to the board meeting in which they were awarded. A growing number of corporations have become the targets of federal investigations and received widespread media coverage based

stock option awards in violation of applicable laws.

Before pursuing M&A transactions, directors should work with legal counsel to make sure all of their corporation’s previous option grants have been dated, disclosed and accounted for properly. Review of stock option grants should be an important part of pre-acquisition due diligence to avoid assuming liability for another company’s grant practices inadvertently. Boards should also be cautious about granting new options soon before a company plans to announce positive news that may increase share prices—such as a merger or acquisition.

Despite significant publicity about the pitfalls associated with stock option backdating, the M&A market appears to be learning how to assess these new risks and factor them into transaction negotiations. At least two corporations have already announced agreements to acquire technology companies subject to backdating

investigations—indicating that some boards may even view backdating as a strategic opportunity to purchase other businesses at reduced prices.

Three Steps to Prevent Problems

To avoid executive compensation problems that can impede or delay M&A transactions, directors should proactively identify likely shareholder and regulatory stumbling blocks, minimize them to the extent possible and oversee full and accurate public disclosure of compensation packages.

1. Understand all details of executive compensation packages.

Before acquiring a company or preparing to sell one, a company's board or compensation committee should conduct thorough due diligence on executive compensation components related to the transaction and the events that will trigger it, including a review of all executive employment agreements, no matter how sensitive. Typical forms of executive compensation that may be triggered by a merger or acquisition include:

- Change of control payments (so-called “golden” parachutes)
- Tax “gross-ups” in which the company reimburses executives for taxes paid on their remuneration (including the 20% excise taxes on excessive golden parachutes)
- Accelerated vesting of stock options and release of restrictions on restricted shares
- Contributions to retirement plans or crediting the executive with service up to retirement age (even if the executive is not near retirement)
- Continuation of medical and life insurance benefits
- Forgiveness of corporate loans

2. Revise potentially objectionable compensation structures.

Shareholders and the government are more likely to challenge M&A transactions if the executive compensation costs provide no shareholder value. In general, investors prefer to link executive compensation to the performance of the ongoing company.

Compensation that appears typical in an industry may still generate criticism, and precedent doesn't guarantee continued acceptance in today's market. Consider revising compensation structures that include the following items, which can be particularly objectionable to outside observers:

- Golden parachutes that exceed customary practices for the industry and the executive's level of seniority, especially if the executive retains a management role
- Cashing out options instead of rolling them over into new options in the ongoing company
- Extremely expensive tax gross-ups (many boards may be surprised to find out how much these will cost a company and should request that they be calculated before a transaction)
- Compensation granted solely for participating in the deal—particularly where poor financial performance made the company an attractive target

In addition, certain types of payments to executives who own stock in their company and changes to their compensation packages preceding M&A transactions can trigger Rule 14d-10 of the Securities Exchange Act of 1934 (the “best-price” rule). By entitling all security holders to receive the same payments, this rule can make tender offers prohibitively expensive. The SEC has proposed

Executive Compensation in Recent Deals Sparks Shareholder Resistance

Institutional investors controlling trillions of dollars of corporate securities have become more aggressive in attempting to exert their influence on M&A transactions based on compensation concerns. This past fall, the California Public Employees Retirement System (CalPERS, the largest US public pension fund) opted to oppose the \$8 billion merger of United Health Group and PacifiCare Health Systems Inc. unless the companies held a separate shareholder vote on proposed executive bonuses to be paid as a result of the transaction. CalPERS publicly criticized PacifiCare for failing to disclose merger discussions with United Health when PacifiCare shareholders voted on the company's compensation plan a few months before the merger was announced.

In 2005 the Canadian brewer Molson Inc. modified some of its proposed change of control payments to mollify institutional shareholders before its merger with US brewer Adolph Coors Co. In AXA Financial's 2004 acquisition of US financial services company The MONY Group, MONY shareholders filed legal proceedings challenging public disclosure of executive compensation packages. The court delayed the transaction until MONY enhanced its disclosures about change of control payments in the documents used to solicit shareholder approval. Public pressure and threats of shareholder opposition to the deal then forced MONY executives to forego approximately \$7 million in payments.

Shareholders and the government are more likely to challenge M&A transactions if the executive compensation costs provide no shareholder value.



adopting amendments to clarify that the best-price rule does not apply to most employment compensation and benefits. Until then, boards should review executive compensation arrangements with legal counsel to ensure that they do not eliminate opportunities for tender offers—often the most expeditious method of completing a transaction in a competitive situation.

3. Ensure proper disclosure.

Directors can reduce certain types of legal challenges to M&A transactions by disclosing accurate, complete information relating to executive compensation in public

filings and communications with shareholders. Allegations of insufficient disclosure can delay a transaction or require restructuring of compensation packages. Recent SEC and Congressional activity indicates that disclosure requirements will most likely continue to evolve. So work with your counsel to ensure appropriate disclosure.

Conclusion

The pressure has mounted for boards and compensation committees to develop transparent pay systems based on principles of independence, performance, fairness and long-term value in determining executive pay

when acquiring or selling a company or set of operations. If you expect to be active in the M&A deal market in the near future, take these simple precautions to prevent compensation issues from interfering with promising business opportunities.

Kenneth A. Raskin is a partner at White & Case LLP in New York and the global head of its Executive Compensation, Benefits and Employment Law Group. He concentrates on executive compensation and employee benefits law, and provides counsel on the entire spectrum of employee benefit concerns. John M. Reiss is a partner at White & Case LLP in New York and the global co-head of its Mergers and Acquisitions Group. He represents corporations and private equity groups in M&A, private equity, securities, and financing transactions of all types.



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Assessing Talent: A Critical Step in M&A

By Tim Morin

Making a bad M&A decision around talent, particularly top management, can lead to millions of dollars in losses.



Tim Morin

According to *The Wall Street Journal*, 2006 is on pace to be the most active merger and acquisition year in history, with the

value of completed deals projected to reach \$3.5 trillion by year-end. Given the high risks to shareholders that these deals entail and the increased scrutiny of the director's role in M&A due diligence post Sarbanes-Oxley, Time/AOL merger, etc., board M&A committees are digging deeper to make sure they understand transactions to a greater degree than ever before. And directors are increasingly advising management to more formally assess an organization's people, especially a company's top executives, just as they do its financials during pre-deal due diligence.

Making a bad M&A decision around talent, particularly top management, can lead to millions of dollars in losses, when you take into account vested management options or stock, severance costs and executive search expenses—not to mention the loss of morale, momentum and growth opportunities. Ironically, directors and management have traditionally spent less time analyzing management as part of pre-deal due diligence because of the speed at which these transactions happen and the pre-conceived notion that reliable metrics



regarding management quality are hard to come by.

However, a rigorous assessment of the senior management team of a target company especially makes sense in the context of a merger, given that these key executives are expected to navigate their companies through a period of wrenching change during this integration. The acquiring company's board and management need to confirm that the executives who thrived within the target

company's corporate culture can successfully adapt to:

- The new culture of the acquiring company
- Shifting strategies
- A different operating "style"
- A new reporting structure

What does a "rigorous" assessment look like? We recommend a careful examination of potential red flags identified during other areas of

the M&A due diligence and a comprehensive interview of each member of the leadership team, during which the strengths and weaknesses of the executive is examined in light of these risks.

“360 degree” interviews where current and/or former bosses, peers and subordinates of the executive are interviewed also provide critical data that may be missed during management interviews as the top executives are likely to put on their best faces during the acquisition talks. In some cases, the list of interviewees should be extended to include customers, vendors and consultants who have had relationships with the executive. Supplemental psychometric/psychological tests can also be administered to provide a useful framework for assessing the ways that the executive’s personality and style may impact his or her performance at the new merged company.

Specifically, a professional assessment should investigate an executive’s:

- Capability to successfully lead the company during transition to a new configuration
- Cultural fit
- Interpersonal adaptability and openness to consultation and advice
- Sensitivities to ethics, laws, and regulations
- Communication skills and style
- Vision capability
- Emotional intelligence
- Personality

Increasingly, directors are realizing that it often makes sense to bring in outside expertise in assessing

Directors and management have traditionally spent little time analyzing management as part of pre-deal due diligence.

management of a company before the transaction—much as an investment bank would be brought in to deliver a fairness opinion. Of course, the executives of the target company may resist being “poked and prodded” with a formal, drawn-out assessment. After all, they are doing their own due diligence on the acquiring company and the acquirer’s board and management must be sensitive to the risk of overstepping in their screening process.

Therefore, we recommend that any executive assessment program, whether within the purview of a merger or the normal course of business, be designed and delivered in the context of developing the executive. The discoveries made during an assessment often lead to decisions around “on-board” coaching and other post-deal developmental steps for members of the leadership team. This information will also allow the board to build specific goals into the executive’s performance parameters.

Pre-deal talent due diligence shouldn’t stop at the executive level. We also recommend an employee attitude survey as a way to gather insights into the company’s health beyond the C-suite. This could be a quick, customized online questionnaire that asks what the employees at large feel about:

- The leadership team
- The company’s relationship with its customers

- The competitive landscape
- The overall level of employee engagement
- Condition of the physical plant
- Other potential red flags

Like the assessment of the company’s top executives, an analysis of the mood and engagement-level of the target company’s employee population should be done with sensitivity and in the context of developing and improving the business. Such an assessment should entail taking a healthy look at the current state of the business, not just performing a survey to determine whether the company will be sold or merged.

Leadership assessments and employee surveys are also effective tools for capturing information about the target company’s culture. This can help the board and management make educated decisions about whether to leave the target’s culture as is, rather than integrating it kicking and screaming into the acquirer’s. It often makes sense to work on bridging the differences creatively, hopefully keeping the best of both.

As expectations and benchmarks for directors continue to evolve and become more measurable, a more comprehensive and rigorous approach to M&A talent due diligence becomes an increasingly wise approach.

Tim Morin is chief financial officer for WJM Associates, Inc., an executive and organizational development company.

Getting Post-M&A Executive Compensation Right

By Blair Jones and Seymour Burchman

Successfully designing and executing a post-transaction reward program



Blair Jones

The announcement of a proposed merger or acquisition generates unbounded excitement about potential opportunity. Yet the success of that transaction can rest in large part on the strength and accuracy of the pre-M&A legwork. Careful and precise consideration of all the variables influences whether a transaction will live up to its potential or get lost in the pack, a disappointing also-ran.



Seymour Burchman

Executive compensation is a critical variable requiring consideration early on. Executive compensation decisions will help signal what will be important in the new organization and lay some groundwork for how to get there.

Done right, executive compensation can facilitate strategy achievement. Done wrong, executive compensation will be, at best, a neutral contributor to future success or, at worst, a drag against progress.

Where Companies Fail

Unfortunately, in their rush to get their deal done and move on, many companies spend too little time considering how executive compensation can help the integration process. Instead, they pursue practices, such as the following, that lead to suboptimized executive compensation solutions:

Imposing legacy practices on the acquired company or vice versa.

Companies frequently force a “best of both” design or adopt the acquiring company’s pay program without thoroughly thinking it through. While adopting one company’s practices may make sense, the decision should spring from seasoned analysis, which subsequently is made transparent to executives. Buy-in and a higher probability of implementation success require laying the groundwork in a fact-based manner and evaluating the

characteristics of the new combined entity and what they may imply for appropriate compensation design.

For example, an established department store chain acquired a specialty retailer, but smartly recognized that imposing its practices could impede the specialty retailer’s entrepreneurial culture. Therefore, the department store added some legacy benefits but maintained the entrepreneurial incentive designs to keep executives comfortable yet energized.

Executive compensation decisions will help signal what will be important in the new organization and lay some groundwork for how to get there.

Following the leader.

Competitive benchmarking can identify potential vulnerabilities versus the competition and appropriate overhang and dilution levels. Yet what worked in one transaction is not necessarily applicable to others. Therefore, merging companies must evaluate “typical” practices in the context of the new entity’s business situation and talent needs. For example, while stock options often are effective at the time of transaction, other incentives that reinforce achievement of key post-transaction milestones, such as performance-restricted stock, may hold more motivational power.

Feeling pressure to provide all rewards up front.

Often, companies are inclined to make executive compensation as big an event as the transaction itself. Executives may view this as their “one big chance.” However, business circumstances and talent needs evolve over time. Therefore, a three- to five year plan for how executive compensation will play out better supports business strategy rather than providing all awards up front. That way, if goals prove easier or more difficult to

achieve than expected and/or if incumbents in key roles change over time, pay design can respond to current needs. For example, executives in an acquisition that initially gets a good reception but then takes longer to realize expected benefits may experience significant declines in morale if heavily front-end loaded incentives fail to deliver as quickly as anticipated.

Companies frequently force a “best of both” design or adopt the acquiring company’s pay program without thoroughly thinking it through.

Getting it Right

Successful design and execution of a post-transaction reward program requires a holistic approach to program design. This means understanding the ultimate vision for the transaction by considering four factors:

Strategy and Financial Structure

- What will be the new entity’s major business strategy, its critical success factors, major challenges and time horizon?
- What is driving the transaction (e.g., industry consolidation, access to capital markets or other financing sources, exit strategy)?
- What is the optimum balance between the potentially competing interests of shareholders, executives, employees, and the financial community?
- How will the balance sheet be transformed by the transaction?
- What are the key metrics?
- What is the urgency and stretch of goals?
- What are the time frames for measurement?
- How prominent is the pay needed to drive strategy and results?

Leadership Style

- What are the values, leadership qualities, and cultural characteristics that the company needs to develop in order to achieve the articulated business strategy?
- What prominence pay will need to take vs. other management levers in driving performance?
- What are the incentive vehicles that will work?

Competitive Landscape

- How will the profile/skills of employees need to change post-transaction?
- What implications will that have on sourcing new talent and business/ financial/human capital benchmarking?

- What are the competitive pay levels and opportunities?
- How have other organizations addressed these issues in analogous transactions?
- What are the human capital programs of relevant benchmark companies?
- What are the critical positions and skills and how should they be paid?
- What is the guidance on pay levels, overhang, and dilution?
- How might peer groups need to change?
- What’s the importance of following competitive practices regarding mix of pay?

Legal/Regulatory Requirements and Restrictions

- How will regulatory, tax, and accounting issues affect human capital programs?
- What kinds of legal documentation need to be crafted?
- What new corporate governance structures need to be created?
- What are the legal and regulatory requirements and constraints for the company and employees?

The answers provide the context for clarifying the new entity’s compensation philosophy and designing programs that sustain focus and performance both during and after the transaction. For equity programs in particular, the questions help to inform which vehicles will be most effective in motivating and retaining talent, what levels of overhang and dilution are acceptable, who should receive equity, and in what amounts. Since the answers to these questions will be different for different companies, the range of solutions should differ as well.

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In Defense of Stapled Finance

By Kevin Miller

Despite concerns regarding conflicts of interest, stapled finance remains an important tool for companies trying to obtain the highest possible price for a business being sold.



Kevin Miller

The phrase “stapled finance” is generally used to refer to prepackaged financing terms offered by the seller’s financial advisor

to financial buyers. Typically, the Confidential Information Memorandum sent to prospective purchasers regarding the business being sold informs potential purchasers of the availability of stapled finance and how to obtain information regarding its terms. In some cases, sellers have declined to make the terms of the stapled finance available to strategic buyers—who typically do not want or need the same type of financing—to prevent them from reverse engineering estimates of the maximum amounts financial buyers will be capable of paying using the stapled finance and thus impairing the competitiveness of the auction.

Generally, all bidders are offered the same terms, at least initially, but the ultimate financing terms agreed may be tailored to the needs and attributes of a particular purchaser based on a variety of characteristics

including differences in business plans and capital structures and the ability of certain financial buyers to justify better terms based on past performance.

Recent events have focused increased attention on potential conflicts relating to stapled finance. For example, Vice Chancellor Leo Strine’s Toys “R” Us opinion, included the following dicta:

“The [decision of the financial advisor to request the Board’s consent to provide financing to the winning bidder] was unfortunate, in that it tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms. Far better, from the standpoint of instilling confidence, if First Boston had never asked for permission, and had taken the position that its credibility as a sell-side advisor was too important in this case, and in general, for it to simultaneously play on the buy-side in a deal when it was the seller’s financial advisor. In that respect, it might have been better, in view of First Boston’s refusal to refrain, for the board of the Company to have declined the request, even though the request

came on May 12, 2005, almost two months after the board had signed the merger agreement.”

That view, coupled with the NASD’s proposed rules regarding fairness opinions and various articles in the press, have focused attention on two major sources of potential conflicts in connection with stapled finance:

Conflicting Roles

Even as an independent contractor (as opposed to an agent or fiduciary), the seller’s financial advisor generally has a duty to act in good faith, presumably in a manner it believes is not opposed to the interests of its client, the seller. But as a source of financing for a prospective purchaser, the financial advisor will insist on the ability to exercise rights in its own interest, which may at times be in direct conflict with the interests of the seller (e.g., the contracted right common in financing commitments to declare that a material adverse change in the business being sold has occurred and withhold financing from the buyer).

Conflicting Fees

Although most courts have recognized that sell-side advisory

Concern has been expressed that the payment of significant fees contingent upon the closing of a transaction creates an incentive to support transactions at inappropriately low price levels.

fees based on a percentage of the aggregate transaction consideration align the interests of the seller's financial advisor with the interests of the seller, concern has been expressed that the payment of significant fees contingent upon the closing of a transaction creates an incentive to support transactions at inappropriately low price levels. That concern is exacerbated if the financial advisor stands to earn substantial additional fees from financings that are equally contingent upon consummation of the transaction.

- result in speedier agreement and consummation of a transaction because the provider of stapled finance will have completed its due diligence and will have obtained the necessary internal approvals to provide financing commitments;
- create a financing floor that limits the ability of the winning bidder to renegotiate the purchase price based on a claimed deterioration in the terms of the financing available from third party sources of financing; and

choose to sell businesses that may be attractive to other financial sponsors. According to the co-head of European leveraged finance at Deutsche Bank, "Staple financing was offered by banks this year in about 90 percent of the auctions in Europe where buyout firms sold businesses to other buyout firms."

For their part, investment banks are well aware of the concerns regarding their potential conflicts of interest and have implemented a variety of policies and procedures designed to address them, including:

It's also worth noting that stapled finance is routinely used by financial sponsors when they choose to sell businesses that may be attractive to other financial sponsors.

Despite these conflicts or potential conflicts, the benefits of stapled finance can often be compelling. The availability of prepackaged financing may:

- induce more bidders, as it confirms that a transaction is financable without the investment of any time, money or other resources by prospective purchasers and, if the sell-side advisor is one of the seller's traditional lenders or sources of financing, signals that a financial institution that is familiar with the business being sold is comfortable with the business's ability to service the debt to be incurred under the stapled finance package;
 - create a more competitive bidding process, by ensuring that at least one source of potential financing is available to all interested bidders, even as financial sponsors increasingly require potential sources of financing to go "exclusive";
 - provide greater certainty of consummation as a result of the demonstrated capacity of a small group of investment banks, which may include the seller's financial advisor, to successfully market the significant amounts of high yield securities and/or loans necessary to finance large leveraged acquisitions.
- Some sellers also believe that it can be advantageous to have their financial advisor involved in the buyer's financing because the sell-side advisor will be less likely to pull its financing commitment as a result of a deterioration in the business being sold or other problems than third party sources of financing with no historical relationships with the seller or other interests in the transaction.
- It's also worth noting that stapled finance is routinely used by financial sponsors, the most sophisticated market participants, when they
- the use of separate teams of bankers to provide financial advisory services to the seller and to work on financing arrangements for different bidders;
 - the implementation of informational barriers designed to prevent the unauthorized disclosure of information from the financial advisory team to financing teams, and vice versa;
 - generally requiring that all bidders be informed that stapled finance is being made available and that the terms of the stapled finance be provided upon request to all bidders, or at least all financial buyers;
 - permitting potential purchasers to freely choose their preferred sources of financing;
 - refusing to offer stapled financing when representing

(continued on page 49)

It's Time to Reinvent Deal Lawyers

By Robert A. Profusek

What should lawyers be doing to truly help managements and boards address significant M&A issues?



Robert A. Profusek

Until the 1980s, the M&A process was rather genteel, at least from the lawyers' perspective. Transactions typically took many months to put together from the initial business contact, through the "due diligence" or investigatory phase, negotiation of formal documentation and obtaining regulatory clearances. The lawyers focused on arcane drafting points, legal opinions, good standing and incumbency certificates in a sort of capital markets High Tea.

sellers can gear up. And deal-busting alternative transactions can pop up quickly in the current environment.

Despite this routinely pressurized, perilous environment, many (if not most) deal lawyers remain largely on the sidelines, more shamans than counselors, performing rituals of dubious value. Representations, closing certificates and due diligence documents, and carefully worded we-never-depart-from-it indemnity boilerplate didn't do much for the banks writing billion-dollar checks to get out of the Enron securities class actions.

Yet we M&A attorneys could indeed add substantial strategic value for

The so-called "due diligence" representations requiring lists of customer contracts, benefit plans, leases and the like should be relegated to where they belong—due diligence (more on that later). Likewise, the repetitive "specialist" reps—including their redefined terms—ought to be jettisoned. They should not be permitted to substitute for real due diligence or obscure actual thinking.

In sum, the basic forms of merger, divestiture and other transaction documents haven't changed in decades. But we know that the world has, radically. Consequently, lawyers who treat the deal document as a primary focus are not adding much

Despite this routinely pressurized, perilous environment, many (if not most) deal lawyers remain largely on the sidelines.

But that decade's hostile takeover wave shook some of us awake, with target companies needing to roll out litigation-centered defenses in a decidedly ungentle four-to-eight-week spasm of activity.

Today, the timeline for most deals is measured in weeks, not months. The need for speed is driven by several factors. The risk of leaks has been multiplied by inherently leaky new communications technologies, intensified media interest in big deals and the auction-driven expansion of the number of players. Acquirers need to tell their story to analysts and financial media in an organized, positive fashion before the short-

management and boards, given some retooling of our role.

Repetition

Merger documents for public company deals have become the intellectual equivalents of deeds in a real estate deal. Half of the words merely repeat what has been said somewhere else. What do the environmental, labor or other regulatory representations really add that is not covered by the basic compliance-with-laws representation, backed up by the financial statement/SEC compliance representations? Indeed, some of them are just silly. Has anything *ever* happened in a deal because all the Form 5500s required by ERISA weren't filed?

value. With the democratization of information through the internet, the information advantage that some of us used to have is gone.

What We Should Be Doing

What should lawyers be doing to truly help managements and boards address significant M&A issues? They might start by answering questions like these:

- Are there unresolved audit adjustments?
- Were fraud hotline reports made?
- What are the control weaknesses?
- What is the control environment?

Some important legal mechanisms invented in the 1980s are still being cloned today as if the legal, risk-environment and governance changes of the subsequent decades never happened.

Golden parachutes, for example, are written as if the main risk was the hostile cash tender offer. Those still happen, but the real risks today are much more varied, and parachutes very often don't work at all in private equity deals or hedge fund "wolfpack" attacks. Poison pills won't work against wolfpacks either.

On a more fundamental point, the risk that corporate directors could be held liable for actions in M&A transactions became real 20 years ago, and there can be little doubt that risk levels have vastly increased since then. The fact that a board of directors acts quickly is not necessarily determinative of whether it has satisfied its duty of care. Accordingly, it is incumbent on legal advisors, working with management and the financial advisors, to develop a board deliberative process sufficient for the directors to satisfy their legal duties and, equally important, to feel that they had sufficient information to make a reasonable decision, all within today's compressed M&A timeline.

To be sure, in the immediate aftermath of the passage of the Sarbanes-Oxley Act in 2002, the courts seemingly backed away from traditional principles of director conduct (and liability) in transactional justification cases. However, the courts have recently reaffirmed that boards of directors have the authority to oversee the M&A process in the manner in which they see fit, without risk of the judicial nitpicking and second-guessing so evident in the immediate post-Sarbanes-Oxley period, so long

as they act reasonably and in a manner they believe in good faith to be in the company's best interests.

The traditional fairness opinion has in many instances become a substitute for real financial analysis and ought to be discarded or at least relegated to a less important role. Instead, a financial advisor ought to present meaningful, clear analysis of how the deal at hand stacks up when measured against comparable transactions, what the analysts will think when compared to peer transactions, and how the transaction should be positioned in the rollout. This requires that the

Some important legal mechanisms invented in the 1980s are still being cloned today as if the legal, risk-environment and governance changes of the subsequent decades never happened.

financial advisors *engage* with the directors in a meaningful discussion of the matter, not race through forty pages of charts at the tag end of a three-hour board meeting.

Due Diligence

Nowhere is the need to discard rigid traditional processes more crucial than with respect to due diligence.

Due diligence has, of course, assumed more importance as the heady mindset of the 1990s has been replaced by a sober recognition

that even the most well-conceived acquisition or merger can result in a loss of shareholder value if contingent liabilities, contractual or regulatory issues or other existing or potential problems are not properly provided for in pricing or the other terms of the transaction. Unfortunately, given the auction process and technology like the virtual data room, due diligence has in many cases become a mechanistic effort to amass a paper record.

Due diligence can no longer be the province of a few otherwise unoccupied legal assistants and technicians. Instead, this is the area in which top-flight counsel, alone or in conjunction with other outside experts, can provide the greatest value, not polishing off the same lock-up provisions that have been in dozens of other merger agreements signed earlier that month. The major PE shops have figured this out. They don't want a summary of pending litigation; that is of little use to them. Instead, they want experienced litigators knowledgeable about the pending or threatened cases to estimate, fairly, the dollar cost of settlement; they want regulatory lawyers who can give them real insight into where the laws are *going*, not what they are; they want labor lawyers who can assess the potential competitive import of a neutrality clause in a union contract in the context of an exit.

That is to say, they want substance, not paper. I can't think of a better rallying cry for the consumers of M&A legal services.

Bob Profusek, a partner in the New York office of international law firm Jones Day, is an advisor to substantial businesses, focusing on M&A/takeovers, restructurings, and corporate governance matters. He co-chairs the firm's global M&A practice.

Hidden or unrecorded liabilities in the acquired business ranked as the top tax issue facing M&A participants.

Falk & Wright, from page 35

M&A Activity Includes Increased Cross-Border Deals

Among companies that completed at least one M&A transaction in 2005, half completed at least one cross-border deal, and the percentage of companies completing at least one cross-border deal is expected to increase in 2006.

Hidden Issues Can Impact Successful Deals

Not all deals work out the way they were intended. In fact, among respondents, 6 out of 10 rate their companies successful at achieving major M&A deal objectives and one third are neutral. Still, only 4 out of 10 respondents say they perform postmortems to assess acquisition against plan.

Survey respondents also warned that a number of challenges could continue to affect the success rate of transactions. For example, hidden or unrecorded liabilities in the acquired business ranked as the top tax issue facing M&A participants at 70 percent, and half of the respondents cited incomplete planning prior to the transaction as a factor contributing to a deal's objectives not being met.

M&A Roles and Responsibilities

Two thirds of those surveyed said that the corporate controller has the primary responsibility

for implementing accounting for acquired assets and liabilities.

In addition, when acquiring a business, 7 in 10 stated that they use external advisors.

Tax Professionals Becoming More Integrated in M&A Deals

Until recently, tax professionals have taken somewhat of a back seat to M&A professionals when it comes to participating in deals. But the need to include tax professionals in assessing and evaluating tax-related issues—and thus mitigating deal-related costs—has put more of a premium on their services. For instance, a majority of survey respondents say that tax is involved with corporate development in transaction evaluation. In addition, the majority of the tax and M&A professionals polled said that the ability to obtain a tax basis step-up of a potential target increases the purchase price.

Companies looking to reap the benefits of an acquisition, merger, or divestiture have increasingly taken advantage of lower interest rates, enhanced competitive positioning, and the immediate impact of greater scale to improve their position and strength in the marketplace.

The results of KPMG's M&A Outlook Survey suggest that 2006 M&A activity will surpass last year's record performance and be strong across several industry sectors, including telecommunications, banking, and electronics. Yet, the tax and M&A professionals polled acknowledge that their companies face several hurdles in closing those deals, including unrecorded liabilities at the target company and poor pre- and post-deal planning.

Greg Falk is principal in charge of KPMG's M&A Tax practice. Malcolm Wright is national services leader of KPMG's Transaction Services practice.



There is a strategic promise behind every acquisition—and leadership has to be able to deliver on that promise.

bankers who will guide the company through the financial aspects of the deal and the lawyers who will provide legal advice.

Nevertheless, some companies resist the kind of people due diligence that puts key positions up for grabs and addresses team and integration issues up front, on the grounds that it's too costly and adds complexity to the deal. But the real question is not how much the process costs, but how much value is lost by not making a meaningful effort to leverage the best talent. Undertaking a comprehensive and genuinely objective leadership talent and team assessment may be challenging, but the opportunity cost of losing key talent that could have been retained far outweighs the direct cost.

It is the talent of those acquired executives that made the company a desirable target in the first place.

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special committee evaluating a management buyout; and

- effectively requiring sellers desiring a fairness opinion to obtain a fairness opinion from an unconflicted financial advisor.

Ultimately, many companies get comfortable with their financial advisors providing stapled finance because the members of the investment banking team providing financial advice to the seller are often trusted advisors who have proven their worth and integrity over time and the companies do not believe that they will risk their reputation and a longstanding and mutually beneficial commercial relationship on one fee opportunity.

Nevertheless, the decision by a seller to allow its financial advisors to provide stapled finance should not be undertaken lightly. To weather potentially skeptical

judicial scrutiny, companies should establish a detailed record demonstrating that the board's decision was fully informed and followed careful consideration and deliberation of the issues, including an evaluation of specific risks and benefits and, if appropriate, was conditioned upon the implementation of certain procedures and restrictions, such as those described above.

In such circumstances, a properly functioning and rational board of directors may reasonably conclude that the benefits of allowing its financial advisor to provide stapled finance (or offering to provide or otherwise assist the winning bidder in obtaining financing after the completion of the auction) outweigh the risks posed by the potential conflicts and such a decision should be legally protected.

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an independent firm to value an acquisition or sale is related to due diligence and the questions asked during the information gathering process. The valuation firm can facilitate the flow of information between management and the board and help all parties understand the fundamental concepts and assumptions in making the combination a value creating process. In every analysis, there are key underlying assumptions that provide the basis for financial forecasts or business plans.

An important service a valuator can provide is to test the reasonableness of any of those key assumptions

that the board feels is problematic. Overly aggressive sales growth rates, expanding profit margins, anticipated market share increases and other aggressive "hockey stick" projections are quantitative examples that can be tested. Qualitative assumptions such as depth of management, adequacy of staff and relocation decisions can also be analyzed.

Bruce Bingham is senior managing director of Trenwith Valuation, LLC and the chairman of the International Valuation Standards Board. Since 1978, Bingham has been actively involved in valuations, mergers and acquisitions and other financial consulting matters. In his current position, Bingham is responsible for all of Trenwith's valuation activities in the United States and for U.S. client internationally.

differences, can be the toughest. The best integration efforts tackle the cultural differences head-on, determining and communicating the solution early. Whether the solution is to take the best from both cultures or to decide that one culture will prevail, management must address the issue in the first 30 days and be open and transparent.

It is impossible to identify and plan for solving the tough issues too early in a transition.

Are We Executing a Detailed Communication Plan?

People have an unending thirst for information, and if they don't receive a steady stream of honest, straightforward information regarding the merger, rumors will take over. People may not like the message, but they always appreciate being told the truth. For example, if decisions have already been made regarding leadership roles, headquarters location, and facilities closings, these need to be communicated as soon as practical.

It is very important that management communicates the vision, priorities,

and ground rules for the transition process as early as possible. This is a great opportunity for management to articulate and drive cultural, behavioral, and performance change in the combined organization. But the content must be well thought through and communicated over and over using every possible vehicle, from emails and voicemails, to brown-bag lunches and small group discussions, to town hall meetings and videoconferences.

It is impossible to over-communicate in executing a merger.

Do We Have a Small, Focused Team Working Full-Time on Driving the Transition?

It is a massive job to integrate the operations of two organizations, and expecting the management team to do that while continuing to operate the business—in effect doing two more-than-full-time jobs—is a recipe for disaster.

While it might seem counter-intuitive, involving everyone in the integration is exactly the wrong thing to do. Management must communicate with employees regarding what is going on, but have nearly all employees focusing on just their jobs. A small team of senior people and a Chief Integration Officer accountable to the CEO should take full responsibility for the integration program and run the program like a turnaround.

It is impossible to assign a team with too much experience to the integration.

Negotiating the “deal” and getting to closing is no easy task, but the work involved in integrating two companies after the closing dwarfs the pre-closing tasks in terms of complexity, risk, and sheer volume of work. However, if the board can ensure that management is addressing the six areas outlined above effectively, it can help the company be part of the one-third that does realize value from an acquisition.

Bruce Myers and Jim Peters are managing directors with AlixPartners, a firm which solves complex operating, financial, litigation, and transactional challenges.

Speed is probably the most important factor in a successful integration.



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board building
with a plan for the future

Credentials only get you so far. By taking the time to truly understand our candidates and our clients' boards, Heidrick & Struggles finds more than the right person. We find the right person *to strengthen* your board. With our team-oriented philosophy, we have produced decades of effective boards and enhanced corporate governance. At Heidrick & Struggles, our goal is strategic board building, creating for the long term a continually stronger board and enhanced contribution to your company's success.

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