

Foreword

From Vigilance to Vision

Buckled into your seat, electronic devices off and eyes closed, you're dimly aware of the pre-flight announcement that you've heard countless times before: "In the unlikely event of a water landing, your seat cushion may be used as a flotation device." But have you ever really listened to that message? Could this diminutive cushion, about the size—and thickness—of an iPad, really be used as a flotation device?

Consider this: In 1995, the U.S. Coast Guard discontinued its approval of seat cushions as flotation devices for watercraft under 16 feet (they'd never been approved for larger vessels). Also, the Federal Aviation Administration's Technical Standards Order authorizing the use of cushions as flotation devices was last revised in 1990. It would thus appear unlikely that your cushion would be of much use in the event of a splashdown.

Water landings by aircraft are rare, however, and successful water glides are rarer still. So, perhaps the FAA's rationale is that a small flotation device fits the rarity of actual need. But what of the pre-flight announcement? The FAA cannot possibly believe that the message gives comfort to passengers, when the cushions themselves don't even do that on the flight!

As a director, you receive a continuous stream of information. Unlike the air passenger who tunes out the announcements, however, you try to be vigilant in order to discern from the mix of background and foreground company data those dissonant notes, those underappreciated inputs, those gaps in analysis. You listen to identify the things that don't add up.

But it's getting harder to detect those subtle yet critical notes buried in the morass of reading material now available to directors. Only a few years ago, the volume of pre-meeting materials was limited to the width of a three-ring binder and the size of a standard FedEx box, which typically arrived at the director's office or home a few days before the meeting. As I've pointed out in this Handbook, the director most up-to-speed on these "pre-reading" materials was often the director who made the longest plane trip to attend the meeting. Those directors, poring through their binders stuffed with pre-reading materials, were a common sight in the first-class sections of commercial airliners. The binder was a bulky carry-on, but at least its size limited the volume of pre-reading. Not so anymore.

Today, services like BoardLink permit companies to transmit vast amounts of information to dedicated devices supplied by boards to their

The Directors' Handbook

directors. There is a consequent proliferation of PowerPoints, appendices, memos, advisories, agendas, draft minutes, and so on. There is also a potential collapse in timing, because content can be added or revised and resent without FedEx deadlines. The result: significantly more pre-reading, less time.

As a director, you need your board to put reasonable limits and priorities on this phenomenon. It is true that so long as directors make well-informed decisions without conflict of interest, they should not be held liable for business judgments that do not lead to successful outcomes, and under Delaware law can be exonerated from personal liability by company charter so long as they meet that standard of conduct. However, having more data does not necessarily mean that directors are better informed.

Consider the related issue of the time dedicated to management presentation versus the time allotted for director deliberation during a board meeting. Slide proliferation should not lead to management presentation time crowding out director deliberation time. Not all board sessions require the same ratio of deliberation to presentation time. But if you see that on critical matters of company strategy the presentation of management's recommendations and supporting data has been given too much time on the agenda, then you as a director need to insist that the meeting time be expanded or the presentation materials better edited.

Another phenomenon that needs attention is the erroneous assumption that board member education needs to occur on a daily basis. While there are certainly developments that you need to follow, they largely track with annual business calendars and regulatory responses to business developments.

In the past decade we have seen—and this Handbook has covered in detail—Sarbanes-Oxley, PCAOB audit enhancement, NYSE rule changes for compensation committee and other practices, Dodd-Frank whistleblowing rules and (still evolving) Volcker rule reform, “Say-On-Pay” and so on. I would argue that a “weekly update” rehashing the same topics is less useful than the occasional and thoughtful analysis of how the present architecture of corporate regulation and governance that have resulted from the last decade of reform applies to the situations that directors confront.

F.1 Challenges to Director Merger Oversight

Merger oversight is one such topic that merits further analysis. Given that hostile takeover attempts are at a decade low while friendly mergers are increasing as the economy recovers, it is worth taking a closer look at the “merger objection litigation” phenomenon as it relates to director conduct.

These days, virtually every proposed merger involving a publicly traded company is challenged in court, and often in multiple courts, by shareholder plaintiff class action lawyers. The cases typically seek to challenge the board’s process in approving the agreed sale, and the company’s proxy disclosure used to solicit shareholder approval.

The example presented here draws on recent litigation challenges to boards’ considerations of agreed mergers and related asset sales, and challenges to the proxy disclosures about the background to the merger.

Consider the case of a company with a legacy business that presently has good cash flow but faces challenges from new forms of competition. Its board, on which you sit, decides to explore the sale of the company and/or the sale of a patent portfolio it owns. Let’s look at some of the process steps and issues.

One issue is that management may have existing employment agreements with change-in-control provisions that provide for significant payments to executives in the event of a merger. Those agreements do not disqualify management from leading day-to-day efforts to solicit potential interest in the company from potential acquirors, but the board needs to be aware of that dynamic.

To address this situation, outside directors can contract an independent financial advisor to work with the company, with board oversight, to solicit bids for the company’s shares and/or key assets such as patents. Indications of interest can be taken and developed under non-disclosure agreements (NDAs).

If a bidder makes a cash offer for all company shares (with or without a separate sale of the patent assets), boards of companies incorporated in Delaware should take steps to maximize the cash value received as a matter of legal duty, quite apart from the good business sense of doing so.

That does not mean that the board must conduct an open auction, or even treat each bidder identically. For example, a fully financed bidder with a strong offer may ask for a period of exclusivity, during which the board agrees to negotiate only with that bidder. The bidder may even state that it

The Directors' Handbook

will not further bid without an exclusivity agreement. A board can reasonably embrace such a request, even if it means not dealing with other potential bidders for a time, if the directors believe that granting exclusivity to a strong bidder is a reasonable step toward obtaining maximum value for shareholders.

Another issue is when a board has one or more non-management directors who themselves are associated with a significant investor. If that investor becomes a bidder, the interested director would be recused from board consideration of the bid, and additional care should be taken to ensure that the majority of independent directors address the fairness of subsequent steps.

What about the patents? Sale of company patents complicates things because some bidders may or may not want to bid for the patent portfolio, while others will only be interested in acquiring some or all of the patents. The sale of the patents, unlike the sale of all company shares (or a controlling interest) for cash, will be governed legally by the business judgment rule. In other words, so long as unconflicted directors make an informed judgment about the timing, terms and conditions of the sale, a court will not allow litigants to later reverse the sale or hold directors liable for damages should someone contend that the timing was not ideal, or that the price could have been higher.

Returning to the strong bidder which received a period of exclusivity during which it did due diligence on the company (and, possibly, patents), let's say that the bidder confirms or raises its initial bid. The board will need to decide, with the aid of financial advisors, whether to accept that bid. Even then, however, the board will need to provide that any deal with the bidder (call it Bidder A), will not be final until other bidders are given an opportunity to top Bidder A's offer. Without such a provision, directors cannot be sure that they have maximized the share price. For its part, Bidder A may insist that if it is at risk of being overbid, it is entitled to a termination fee should its bid be topped, because it facilitated the bidding contest. If the termination fee is deemed reasonable (say 3 percent of bid value), directors should be able to accept such terms without liability for doing so.

Now, suppose another bidder (Bidder B) had also shown interest in the company. Further, suppose that Bidder A's offer included a patent sale to a third party, which would reduce Bidder A's costs. Once Bidder A's bid is announced, Bidder B may complain that it too could have offered a similar price if it had included a patent sale to a third party. If so, Bidder B is free

to outbid Bidder A, which effectively is for the value of the company less the value of the patents.

As you can see, the process is complex; each step requires careful consideration of the possible outcomes, which need to be planned for as well. Although these transactions are now challenged by practitioners advocating for a court-ordered amendment to the process or disclosures for which they can claim credit (and a fee award), adherence to the principles referenced in this Handbook (especially conflict of interest avoidance, or disclosure and recusal if extant, and well informed majority independent board business judgment) can go a long way toward effectuating director vigilance in pursuit of director strategic vision.

F.2 What's Next

Please put a comment note in your company-issued iPad that as the global economy recovers, the problems of economic rebound will return. From 1994 to 1997, companies that lagged behind their competitors in pulling out of the recession (which was admittedly much shallower than this one) were under pressure to come as close as possible to matching the results of the market leaders. Otherwise, rumors of market share loss would spread and stock prices would be punished. Company managements with a strong ethical culture were willing to take the hit, but others scrambled to report higher revenues, even if it meant breaking the rules. The takeaway: Revenue recognition is a key risk factor of recovery for companies lagging behind their competitors.

What else? Consolidation is coming. With it will come situations of unbalance as fewer, larger and vastly richer players use economic recovery as an opportunity to protect or expand their footprints. At the same time, shareholder advocates have reduced takeover protections to pitiful levels with a decade of self-promotional annual meeting initiatives that have debilitated proxy voting of staggered boards, meaningful special meeting triggers, rights plan adoption, written consent voting processes and balanced corporate governance over change in control process assurances generally.

The next year will see a resurgence of unsolicited merger activity. But maybe this will precipitate an outcry, and a call for rebalancing values, so that director judgment in setting corporate strategy is given more, not annually less, freedom to strive for success.

The Directors' Handbook

A director's job is exceptionally hard and exceptionally important. Directors' watchwords for 2013 should continue to be vigilance, transparency, strategic vision and conflict of interest avoidance. This edition of the *Handbook* fine-tunes and updates each chapter based on events, developments and input from readers.

Please e-mail your comments and suggestions for future editions and revisions to this handbook to me at the address below. Such feedback has been an invaluable aid to the development of this commentary.

You are busy with your day job and your directorship. If you have a chance to read this handbook, and you do so, I feel as if something good has taken place. Thanks to CSC® Publishing for once again publishing *The Directors' Handbook* and to Meg Campbell for making it happen.

Thomas J. Dougherty
Skadden, Arps, Slate, Meagher & Flom LLP
One Beacon Street
Boston, MA 02108
617.573.4820
Dougherty@Skadden.com

March 2013