Public Company *Insights*

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Conflicts of interest in M&A transactions

What's your board's role?

When a company is acquired, its board of directors should take an active role in overseeing the sale process — including identifying and responding to actual or potential conflicts of interest on the part of the company's investment bankers or other financial advisors. This is one of the lessons gleaned from the influential Delaware Supreme Court's decision in 2015, *RBC Capital Markets, LLC v. Jervis* (the *Rural/Metro* case).

Rural/Metro also offers guidelines for financial advisors. In this case, the court affirmed the Delaware Chancery Court's $75 million verdict against a financial advisor for "aiding and abetting" breaches of fiduciary duty by the company's directors.

Advisor advancing personal interests

The case involved the sale of Rural/Metro Corporation to a private equity firm. In 2010, after Rural/Metro had been approached by potential buyers, a special committee of independent directors was asked by the board of directors to retain an advisor to explore strategic options. These potential options included buying a subsidiary of the company's main competitor, Emergency Medical Services Corporation (EMS).

The factual background of the case is fairly complicated, but, in a nutshell, the special committee engaged RBC as its financial advisor and quickly began to pursue a full-fledged sale, exceeding its board mandate to simply evaluate strategic alternatives. Ultimately, however, the full board ratified the committee's actions.

At the same time, EMS was also marketing itself for sale. Despite the negative impact this had on Rural/Metro's sale process, RBC advised the committee to proceed. One reason for this, the Chancery Court found, was that RBC hoped to use its position as sell-side advisor to Rural/Metro to secure buy-side roles with the private equity firms bidding for EMS.

In addition, RBC aggressively pursued buy-side financing opportunities with the private equity firm that purchased the company, without first consulting the board. And RBC failed to include any valuation analysis in its presentations to the board until three hours before the board voted to approve the deal. The court found that RBC had manipulated its valuation metrics to make the private equity firm's bid appear more attractive.

All of these conflicts of interest placed RBC's interests above those of the company and its shareholders, and none of them were disclosed to the board. And the advisor's actions misled the board into making false disclosures in its proxy statement regarding the merger.

Higher court's ruling

The Delaware Supreme Court affirmed the Chancery Court's finding that the company's directors had breached their fiduciary duties by failing to properly monitor the sale process and by including misleading disclosures in the company's proxy statement. As a result, shareholders were damaged in the amount of just over four dollars per share.

According to the Delaware Supreme Court, the lower court properly evaluated the directors' conduct under the *Revlon v. MacAndrews & Forbes Holdings* standard rather than the more lenient business judgment rule. Under the business judgment rule, courts generally defer to directors' decisions. Under *Revlon*, however, they scrutinize directors' decisions more closely when a sale of control is involved. The court said that this enhanced scrutiny applied as soon as the committee retained RBC and commenced the sale process, even though the board hadn't authorized it to do so and didn't ratify the committee's actions until months later.

The court also found that RBC was liable for aiding and abetting the board's breach of its duty of care, even though the directors themselves were exculpated by the company's corporate charter. (See "Exculpatory clauses protect directors from personal liability" at right.) The court disagreed, however, with the Chancery Court's suggestion that financial advisors serve as "gatekeepers" and are responsible for monitoring their clients' boards. Advisors don't become liable merely by failing to *prevent* directors from breaching their duty of care. Rather, they must induce a breach knowingly, intentionally or with reckless indifference.

Exculpatory clauses protect directors from personal liability

Many states have enacted laws that allow shareholders to include a clause in a corporation's charter that protects directors (and, in some states, officers) against monetary liability for *unintentional* breaches of their fiduciary duty of care. Typically, these "exculpatory" clauses don't provide protection for directors who:

- Breach their duty of loyalty,
- Act in bad faith,
- Engage in intentional misconduct,
- Knowingly violate the law, or
- Engage in transactions from which they derive improper personal benefits.

Often, directors or officers are able to use exculpatory clauses to support a motion to dismiss a lawsuit against them, allowing them to avoid costly litigation. These clauses aren't mandatory. Corporations may adopt them, however, if their shareholders believe that liability protection is necessary to attract quality directors or officers.

Disclosure is the key

Boards of directors are free to consent to certain conflicts. Nevertheless, they should actively monitor the sale process to identify and respond to any actual or potential conflicts of interest. "Because the conflicted advisor may, alone, possess information relating to a conflict," the *Rural/Metro* court said, "the board should require disclosure of, on an ongoing basis, material information that might impact the board's process." From the financial advisor's perspective, ongoing disclosure of potential conflicts of interest is the best way to avoid liability for the board's failure to fulfill its fiduciary duties.

Nasdaq tightens reins on golden leash arrangements

On July 1, 2016, the SEC approved a new Nasdaq rule requiring listed companies to publicly disclose "golden leash" arrangements. It took effect on July 31 of last year. Will this affect your public company? Let's take a closer look.

What are they?

In a golden leash arrangement, a third party — typically a major shareholder, such as an activist hedge fund or institutional investor — makes cash or noncash payments to directors or director nominees in connection with their candidacy for or service on the company's board. Noncash payments might include benefits such as health care coverage or indemnification rights.

Critics of golden leash arrangements argue that they compromise directors' independence and cause them to place the interests of their benefactors above the interests of shareholders as a whole. They also believe these arrangements encourage the compensated directors to focus on short-term results at the expense of long-term value creation.

What does the rule require?

Nasdaq's rule requires a Nasdaq listed company to disclose the material terms of all golden leash arrangements no later than the date on which it files or furnishes a proxy or information statement for the next shareholders meeting at which directors are elected. Alternatively, if the company doesn't file proxy or information statements, the company must make the disclosure no later than the date it files its next annual report on Form 10-K or 20-F. The company should make the disclosure on its website, in its proxy or information statement or, if it doesn't file proxy or information statements, in its annual report.

The rule excludes certain arrangements from the disclosure requirement, including those that:

- Relate only to reimbursement of the recipient's expenses in connection with his or her candidacy as a director,
- Existed prior to a director's candidacy (employment by the third party, for example), provided the director's relationship with the third party has been publicly disclosed, or
- Have been disclosed in a Schedule 14A or Form 8-K for the current fiscal year.

The required disclosure must be made at least annually until the earlier of the director's resignation or one year following the termination of the golden leash arrangement. If a company discovers an arrangement that should have been disclosed but wasn't, it must promptly make the disclosure by filing Form 8-K or 6-K, if required by SEC rules, or by issuing a press release.

The rule permits foreign private issuers to follow practices in their home countries in lieu of Nasdaq's rule. However, they must make certain disclosures regarding such practices.

How will you ensure compliance?

Uncovering golden leash arrangements between your directors or director nominees and shareholders or other third parties is easier said than done. Fortunately, the new rule will deem you to be in compliance if you make reasonable efforts to identify these arrangements, including "asking each director or nominee in a manner designed to allow timely disclosure." To meet this requirement, use director and officer (D&O) questionnaires, or adapt existing D&O questionnaires, to elicit information about golden leash arrangements.

FASB provides guidance on classification of cash flow

In Accounting Standards Update (ASU) No. 2016-15, *Statement of Cash Flows*, the Financial Accounting Standards Board (FASB) provides companies with guidance on how to classify certain cash payments and receipts in their cash flow statements. For public companies, the update applies to financial statements for fiscal years beginning after December 15, 2017, and includes interim periods within those fiscal years.

Rodney Dangerfield of statements

The newest of the three basic financial statements, the statement of cash flows hasn't enjoyed the same respect as the balance sheet and income statement. The FASB introduced it in 1987 to provide financial statement users with information about how a company receives and uses its cash. Unfortunately, a scarcity of guiding principles for evaluating and presenting this information has led to inconsistent practices.

Generally, companies can classify payments and receipts as operating activities, financing activities or investing activities. But if one company includes an item in operating activities while another company includes the same item in financing activities, comparing the two entities' statements can be challenging.

The FASB's update offers welcome consistency and is intended to reduce the diversity that currently exists in practice. It sets basic rules for classifying certain payments and receipts.

8 cash-flow issues

The ASU provides classification rules for eight types of cash flow:

1. Debt prepayment or extinguishment. You must classify cash payments for debt prepayment or extinguishment costs as cash outflows for *financing* activities.

2. Settlement of zero-coupon debt instruments. For cash payments

to settle zero-coupon debt instruments — as well as other instruments with coupon interest rates that are insignificant relative to the borrowing's effective interest rate — the ASU distinguishes between interest and principal. You'll need to classify the portion attributable to interest as cash outflows for *operating* activities, and the portion attributable to principal as cash outflows for *financing* activities. While some companies currently use this approach, many companies classify the entire payment under financing activities.

3. Postmerger contingent consideration payments. How cash payments to settle contingent consideration liability after a merger or other business combination ("earnouts," for example) are classified depends on their timing. If you make payments "soon after" completing the transaction (the FASB suggests three months or less), you must classify them as cash outflows for *investing* activities. After that, classify them as cash outflows for *financing* activities up to the acquisition-date contingent consideration liability, and classify any excess as cash outflows for *operating* activities.

4. Proceeds from the settlement of insurance claims. Classify cash receipts from the settlement of insurance claims on the basis of the nature of the loss. In the case of a lump-sum settlement, classify on the basis of the nature of each loss included in the settlement.

5. COLI proceeds. You will need to classify cash receipts from the settlement of corporate-owned life insurance (COLI) policies as cash inflows from *investing* activities. You'll then classify COLI premium payments as cash outflows for either *operating* activities, *investing* activities or a combination of the two.

6. Distributions received from equity method investees (investments in other companies). Generally, you'll classify distributions that represent returns *on* investment as cash inflows from *operating* activities, while classifying distributions that represent returns *of* investment as cash inflows from *investing* activities. The ASU requires you to elect an accounting policy — the cumulative earnings or distribution approach — to distinguish between the two.

7. Beneficial interests in securitization transactions. A transferor's beneficial interest obtained in a securitization of financial assets should be classified as a *noncash* activity. But, you'll classify cash receipts from payments on a transferor's beneficial interests in securitized trade receivables as cash inflows from *investing* activities. Currently, many companies classify receipts from securitized trade receivables under operating activities, so this change may have a significant impact.

The FASB's update offers welcome consistency and is intended to reduce the diversity that currently exists in practice.

8. Separately identifiable cash flows. It's not unusual for cash inflows or outflows to have characteristics of more than one of the three cash-flow classes. Under those circumstances, you must apply any specific guidance in Generally Accepted Accounting Principles. In the absence of such guidance, you should classify each separately identifiable source or use within cash receipts or payments based on the nature of the underlying cash flows. You should classify cash flows with characteristics of more than one class that can't be separated by source or use based on the activity that's likely to be the predominant source or use for that item.

Go with the flow

In preparation for these new cash-flow classification rules, your company should review the ASU and evaluate its potential impact on cash-flow statements. Then determine whether you need to revise your accounting policies and procedures. The ASU permits early adoption, so get started now.

Are you up to date with conflict minerals reporting?

Ongoing litigation over the SEC's Conflict Minerals Rule, as well as the recent election results, has created uncertainty among public companies. Do you know which companies must conduct an independent private sector audit (IPSA) of 2016 Conflict Mineral Reports (CMRs)? If you're required to complete an audit, it's due by May 31, 2017.

Understanding the rule

The SEC adopted the rule in 2012 based on concerns that groups in the Democratic Republic of the Congo (DRC) and neighboring countries were exploiting certain minerals (tin, tungsten, tantalum or gold) to finance armed conflict in the region. The rule requires companies to disclose any conflict minerals "necessary to the functionality or production" of their products by filing a Specialized Disclosure Report (Form SD) with the SEC.

Companies that believe these minerals may have originated in the DRC or adjoining countries must conduct additional due diligence to determine whether the minerals were used to finance or benefit armed groups. Depending on the results, a company may need to file a CMR that includes an IPSA. Note that the SEC has suspended the audit obligation for all companies except those that disclose they are conflict free.

Pending litigation

In April 2014, the U.S. Court of Appeals for the D.C. Circuit struck down, on first amendment grounds, a provision in the rule that required companies to disclose whether their products are:

- DRC conflict free,
- Not found to be DRC conflict free, or
- DRC conflict undeterminable.

Two rehearings later, the decision stood. In March 2016, the government announced that it wouldn't seek U.S. Supreme Court review.

The case was remanded to the trial court, with instructions to take action consistent with the appellate court's ruling. It's uncertain how the trial court will proceed or how long it will take before the case is resolved.

Moving forward

Shortly after the appellate court announced its decision, the SEC indicated that companies wouldn't be required to make disclosures found to be unconstitutional. In addition, no IPSA is required unless a company *voluntarily* elects to describe any of its products as "DRC conflict free" in its CMR. As of this writing, the statement remains in force, and there's no reason to believe that the SEC will reinstate mandatory IPSA requirements before the May 31, 2017, filing deadline.

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Real Stories, Real Value: Helping Public Companies Succeed

Helping public companies succeed is an important mission at Wipfli. By delivering a powerful blend and wide variety of services, we strive to provide real value for the companies we work with and build lasting relationships. Here's a small sampling of real stories and how we have lived up to our mission.

Growing Abroad

On the path to making a significant acquisition in Europe, a global manufacturer needed ***Tax Due Diligence*** expertise. Through Wipfli's membership in PKF North America (now known as Allinial Global), Wipfli had access to a global network of legally independent firms. Wipfli brought in-depth due diligence and expertise to help the manufacturer navigate the international tax terrain.

Wipfli secured and coordinated the services of a firm located in the specific European country. This gave the manufacturer the "boots on the ground" needed to determine the tax implications of the proposed structure.

Wipfli then helped the U.S. manufacturer determine the best structure for the acquisition and evaluated the proposed purchase price. Armed with this sound information, the manufacturer was able to pursue its largest international acquisition with greater confidence. Wipfli gave the company seamless support and reliable international tax insights, saving the manufacturer travel costs and extending peace of mind.

Being a True Business Partner

Wipfli was providing ***IT Custom Software Services*** to a $300-million private company for several years. The company was acquired by a rapidly growing public company with technology at the core of its business model. The company asked the firm to increase production capacity from approximately 4,000 hours per month to 9,000 hours per month. At the same time, the company was looking to reduce its costs.

Being agile and not a "one size fits all" kind of firm, Wipfli quickly leveraged the resources of SpiderLogic, Wipfli's custom software development division. A solid plan was put in place to ramp up production and streamline staffing.

Today, the company is receiving round-the-clock, coordinated service delivery with a continued focus on high-quality service and results. Wipfli demonstrated our ability to live our mission of being a true business partner and continues to be a preferred outsourced custom software developer for the company.

Doing the Math for Free

A simple, complimentary benefit study conducted by Wipfli led to big savings and a significant refund for a $40-million public company. The company had expanded its facilities several times over the last 15 years. Each time, a ***Cost Segregation Study*** was recommended. An in-depth, engineer-based analysis of the costs associated with the acquisition, construction, or renovation of building projects could have provided the company with savings, but each time management wasn't quite convinced of the value.

When a change in tax law presented the opportunity to carry back losses to previous years, Wipfli proactively explained how a cost segregation study would result in substantial tax savings. To illustrate the potential return on investment, Wipfli performed a complimentary benefit study projecting the tax benefits and quoting its fee.

Seeing was believing, and the company readily agreed to the study. Wipfli was able to secure a refund of more than $1 million on past tax payments for the company.

Steady Service Leads to Savvy Solution

A $200-million retail food and beverage company had previously relied on Wipfli for a number of services, from a benefit plan audit to SOX outsourcing. Wipfli's mission to be a partner, not a vendor, was ultimately put into practice when the company asked the firm for advice and assistance with ***Business Intelligence (BI)***.

Wipfli helped define the necessary analytics, vision, approach, and key performance indicators to then implement a robust BI solution. With insights at their fingertips, the company's management could effectively oversee key initiatives. The solution was leveraged by the company's executive, finance, and marketing teams to extract valuable customer data and build a customer loyalty program. According to statistics, 84% of loyalty program members are likely to choose the program retailer over its competitor.[1] The analytics solution, with guidance from Wipfli, aided the company in monitoring and modifying its loyalty program to optimize its true value.

[1]Loyalty360

Put the power of our public company experience and focus to work for you.

Contact **Ron Hafner** at 952.548.6714 or rhafner@wipfli.com today.

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