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Directors and officers in M&A litigation

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We've asked lawyers from our offices in Spain, France, Germany, the Netherlands, and the U.S. to talk about when directors and officers get caught up in M&A litigation.

To start, let's talk about the company's constituting documents — articles of association, by-laws, and so on. How do they affect whether directors or officers can be held liable in M&A deals?

Pauline Faron, France: In France and Spain, directors' liability can't be limited or modified, not even by the company's constituting documents. Any terms that aim to limit liability or limit shareholders' rights to act against the directors or officers aren't binding. Likewise, the general meeting of shareholders can't decide to strike an action to hold directors or officers liable.

Olaf Gärtner, Germany: A stock company can't limit or waive a claim it may have against a director in advance, but it can three years after the claim. The company can also stipulate duties of the board beyond the statutory law.

Bas Keizers, Netherlands: Shareholders can discharge a director from internal liability against the company during the approval of the annual accounts. This can only be adopted in a shareholders' resolution and is limited to the information in the accounts (or otherwise) given before the discharge. The company can also indemnify the board against the claims of third parties, and this could be included in the articles of association or in the director's employment contract. But this indemnity may not apply to reckless behavior or if serious blame can be attributed.

Ryan Philp, U.S.: Many corporate statutes allow terms to prevent directors from being personally liable for monetary liability for breaches of the duty of care. Terms like this don't apply to breaches of the duty of loyalty or for acts in bad faith, though.

What about the standard for deciding whether a director or officer can be held liable to shareholders in an M&A deal? What is it?

Christine Gateau, France: Directors and officers can only be held liable if they're at fault — that is, if they break laws or regulations, overstep the company's articles of

incorporation, or mismanage the company. Mismanagement is assessed by comparing the behavior at fault with what a reasonable person, acting in good faith, prudently and diligently, would have done in a similar situation.

Carla Wiedeck, Germany: There aren't specific standards, as such, for an M&A deal. Because the deal itself is a business decision, the business judgment rule applies. For tortious acts, the director or officer must have meant to harm the shareholders in an immoral way and cause them a loss.

Jon Aurrecoechea, Spain: Directors who break the law or the company's by-laws are presumed guilty until they prove otherwise. Where directors fall short of their legal duties (of diligence, loyalty, and so on), liability isn't presumed. Instead, the claimant has to prove otherwise and that such actions caused damages.

Manon Cordewener, Netherlands: The board, or the directors individually, can be held liable if they can be blamed for serious instances of mismanagement. This is a high threshold.

Bill Regan, U.S.: The business judgment rule applies here, too, for arm's-length transactions. Two other standards that may apply are enhanced scrutiny, which typically applies where transactions are entered into in response to perceived threats to the corporation, and entire fairness, which typically applies in conflict of interest and controlling stockholder transactions.

What can boards do to make the most of the business judgment rule, or its equivalent in various jurisdictions?

Bas Keizers, Netherlands: One way would be for directors to record the reasons behind their decision-making. If they were to face litigation later on, they could rely on these documents to defend themselves.

Pauline Faron, France: The business judgment rule doesn't exist in France. So there's nothing to stop a court from second-guessing the board's decisions. That said, courts are reluctant to interfere too much. As has been said, directors should really document their decisions and keep this as proof that they acted in the best interests of the company, and not their own.

Jon Aurrecoechea, Spain: Directors must act in good faith, without personal interest in the subject matter, with sufficient information, and following a proper decision-making process. Documenting all the above very much facilitates a subsequent defense in a litigation scenario.

Ryan Philp, U.S.: Boards must be independent and disinterested with respect to the business decision at issue. This can be difficult where, say, institutional holders with large portions of the stock also sit on the board. These situations need careful attention to governance — special committees, for example, that are sensitive to conflict, can be considered. There are many examples of where this sort of special committee governance has resulted in dismissal of litigation.

Olaf Gärtner, Germany: Directors need to make sure their decision-making focuses on solely what's best for the company. If a decision has been taken on the basis of sufficient information and on this basis looks right, yet later turns out to have been wrong, you cannot be punished for it. That's part of the risk of being in business.

And what if a director or officer has a potential conflict of interest? Does the standard vary then?

Pauline Faron, France: To avoid conflicts of interest, these so-called related-party agreements — deals between the company and a director or between two companies where a director has an interest in both — follow a specific procedure. These deals must be agreed by the board, then ratified by the shareholders; otherwise, they can be annulled if the company is harmed. That's the approach in France.

Olaf Gärtner, Germany: If there's a conflict of interest, the business judgment rule doesn't apply. Also, as a precaution, directors affected by the conflict of interest are regularly excluded from the decision-making process around the M&A transaction.

Jon Aurrecoechea, Spain: The duty to avoid conflicts of interest is embedded in the duty of loyalty, which makes any conflict of interest a breach of the duty of loyalty. The standard, then, is there's no presumption of liability. Shareholders must prove the directors' willful or negligent actions caused damages.

Carlijn van Rest, Netherlands: The standard for liability of directors does not vary if the directors have a (potential) conflict of interest. It should be noted, though, that a director should not take part in resolutions if the director has a direct or indirect personal interest that conflicts with the interests of the company. Should the director — in disregard of these provisions — take part in the adoption of the resolution, the resolution may be annulled and the director could be potentially liable.

Ryan Philp, U.S.: And here, a deal in which a majority of the directors is interested will be subject to the entire fairness test. This means the board has to show the deal was the result of an arm's-length fair process that resulted in a fair price.

What's the role of insurance in M&A deals? Where is this heading?

Ryan Philp, U.S.: Buy-side representations and warranties insurance has become increasingly common in private M&A deals. It allows the seller to get its money without the need to hold back a portion of the purchase price in an indemnification escrow. It also helps the buyer avoid having to potentially litigate. To date, there hasn't been much litigation under these policies, but that may start to change.

Carla Wiedeck, Germany: If you do a deal and despite due diligence certain points remain open, warranties and indemnities insurance can provide cover to allow a deal to go ahead.

Olaf Gärtner, Germany: Five to seven years ago, no one in Germany really insured these types of risks. But over the last three to four years, we've seen this type of cover become the rule rather than the exception.

Jon Aurrecoechea, Spain: Reps and warranties insurance, which is quite new in Spain, is beginning to take off. Directors' and officers' insurance is more common. In both cases, the insurance companies generally pay out when obliged. But they can claim repayment from the insured if they are found to have acted intentionally or in bad faith.

Is a company's ability to indemnify or put up the legal fees of its directors or officers named as defendants limited in your jurisdiction?

Pauline Faron, France: In most cases in France and Germany, the company pays for directors' and officers' insurance. (However, sometimes directors and officers are required by law to participate in these payments to a certain extent.) The insurance covers, among other things, the legal fees of directors and officers. As an alternative, French law allows the company to put up or repay the legal fees. Until, and unless, judgment is handed down, the defendant is presumed not liable.

Jon Aurrecoechea, Spain: In tenders and initial public offerings, it would be a conflict of interest to indemnify directors or put up legal fees, because the board would be generally approving such a decision for its own benefit. And for other claims it wouldn't make sense; for example, where the company is the claimant, it wouldn't make sense to pay the defendant's (director's) costs.

Bas Keizers, Netherlands: It's considered unacceptable for a company to indemnify directors for any internal liability against the company due to serious mismanagement. The company can indemnify directors against external liability, that is, claims of third parties. Such indemnity could be included in the articles of association or the director's management or employment contract, but it isn't unlimited.

Bill Regan, U.S.: Corporate law statutes in the U.S. generally allow companies to advance defense costs and indemnify directors for liabilities for breaches of the duty of care. The vast majority of companies uses this authority and provides for broad advancement and indemnification rights in their articles of incorporation and by-laws. The exception to the general rule is that directors typically cannot be indemnified for breaches of the duty of loyalty.

Finally, what's the role of directors' and officers' insurance in M&A litigation?

Ryan Philp, U.S.: The main role is to minimize the risk that a director or officer will become personally liable in shareholder litigation. It can also influence the parties' willingness or ability to settle claims. Insurers often play a small role in the early

stages of litigation and may become more involved if the case progresses or enters settlement talks, such as mediation.

Bill Regan, U.S.: It's worth noting that in recent years, many insurers increased the deductibles that apply to public company M&A claims. The purpose of these increases was to reduce the insurers' exposure to, and financial responsibility for, the "disclosure-only" settlements that until recently had been commonly used to resolve many public company M&A litigations.

If the deductible is reached, D&O policies typically cover the directors' defense costs and, if necessary, liability incurred due to breaches of the duty of care. Most policies, however, contain an exclusion that eliminates coverage when there has been a final adjudication of intentional fraud by a director.

Minimize litigation risk

In general, courts are reluctant to interfere in companies' business decisions provided the board of directors was independent and disinterested. Companies therefore should pay careful attention to the loyalties and affiliations of board members to minimize the risk that shareholders will challenge the legitimacy of the board's decision-making process.

Boards also should pay careful attention to the way their decisions are documented, especially the sensitive decisions. Well-drafted board minutes, for example, can be a valuable tool to defend against claims.

If litigation is initiated, board conflicts can make a claim more difficult to defend. In certain jurisdictions, like the U.S., a much more rigorous standard than the business judgment rule – such as the entire fairness standard – may apply. In other jurisdictions, absent specific safeguards, a transaction may be annulled.

Directors themselves also should be sensitive to conflicts. While most jurisdictions permit a company to exculpate or indemnify directors for certain types of conduct, there are limitations. Insurance typically plays a role in an M&A litigation. D&O litigation may provide another layer of protection against director personal liability. Therefore, companies should notify their carriers and should expect insurers to play an increased role when settlement is in play. Likewise, in private M&A deals, representations and warranties insurance is increasingly prevalent and provides yet another way for some companies to minimize litigation exposure.

As you can imagine, we've only scratched the surface in this write-up. Getting the Deal Through: M&A Litigation 2018 goes much deeper. It covers 13 jurisdictions — Brazil to the U.S. It explores a wider range of the risks of M&A deals. And it brings home just how much getting your deal through matters.

We've recorded two podcasts as well. In these you'll hear about some common themes in global M&A litigation. You can listen to these at hoganlovells.com/malitigation.

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