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CORPORATE GROWTH & M&A

Winners are forged in the fire of economic duress

M&A advice to boards for navigating the inevitable recession

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The psychology of buying and selling companies is much like that of buying and selling individual stocks. Notwithstanding the old adage of "buy low, sell high," most investors do exactly the opposite. When markets are frothy and exuberance is high, the "fear of missing out" leads investors to buy when stocks are overvalued. Conversely, in the depths of a recession or at a market low, investors often let fear drive their decision-making and begin selling. The same is often true when corporate boards consider acquisitions and divestitures — the fear of failure and legal liability can drive poor decision-making and cause boards to miss out on golden opportunities.

Corporate law supports informed risk-taking

It is not unusual for boards of companies — whether they are private or public – to make decisions that are contrary to those that will fuel growth or become paralyzed during these uncertain times. Many times, they become reluctant to make any kind of acquisition or divestiture when the market declines out of fear that their decisions will be scrutinized and second-guessed

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with the benefit of hindsight. Boards are often concerned about the liability exposure they may face if they make a decision that appears aggressive and fails to accomplish the intended result.

Of course, no one can time the market, and it is foolish to try. It's difficult to predict whether a particular market high is the final one before a true bear market occurs. The market can literally have hundreds of new market highs between the end of the last bear market and the beginning of the next one.

Fortunately, both Delaware and Ohio corporate law recognize these truths and accommodate risk-taking. The essence of the corporate governance paradigm is that boards of directors are not liable for bad decisions made in good faith on an informed basis without conflicts of interest.

At a high level, directors owe fiduciary duties to a corporation, namely the duties of care and loyalty. The duty of care requires the board to act in an informed manner after considering all reasonably available information. The duty of loyalty requires the board to act in the best interests of the company and its shareholders, not in any individual director's own interest.

If the board meets both of these duties, directors have business judgment rule protection. This means that a court will not, in fact, second-guess the decision the board made. Directors are also eligible for indemnification and advancement of expenses in certain instances, and directors and officers insurance backstops these obligations.

Obviously, any acquisition should make sense and should be conducted in a disciplined manner. This concept is true in any market. Once a board determines it intends to make an acquisition, however, its members should not then worry about potential liability even if the acquisition is premature or ultimately fails.

Shrewd boards capitalize on others' weaknesses in economic downturns

Clearly, near- and long-term market and economic expectations will influence the price a buyer is willing to pay for an asset. But there are as many quality buying opportunities, if not more, during a recession as during economic expansion. Boards should embrace economic downturns as the perfect time to buy new companies, not as the time to pull back.

The most common lament that we hear in today's mergers and acquisitions environment is that companies are priced too dearly, owners have unrealistic expectations on price and multiples, and there is too much competition for the good deals that are out there. Private equity and strategic buyers, family offices and independent sponsors have trillions of dollars of capital to spend on transactions, and everyone is looking for proprietary deals to avoid this competition and try to lower prices.

When the market eventually softens — and it will — those buyers with the intestinal fortitude to buy in a declining market will see less competition and better pricing.

Think of Mr. Potter and George Bailey battling for the hearts and minds of the citizens of Bedford Falls during the Great Depression in "It's a Wonderful Life," when there was a run on the banks. Mr. Potter offered to buy out the shareholders of Bailey Bros. Building and Loan at 50 cents on the dollar, and Mr. Bailey used his own personal honeymoon money to pay 100%. As he did so, he told the crowd, "Potter isn't selling. Potter is buying. And why? Because we're panicking and he's not. … He's picking up some bargains."

Those who keep their wits about them should profit handsomely when the market recovers.

This time is not different

As with most other bull markets, especially one that has gone on for over a decade, it seems like this time it is different. There is no reason it cannot go on forever. But the economy is ultimately driven by human behavior – the Federal Reserve and Treasury can't bail us out of everything, and eventually there will be another downturn. The catalyst for the turning point is likely to be different from prior recessions, but a recession is inevitable. Now is the time, when the market is at an all-time high, to be especially careful as a buyer. When the market turns, boards should view it as a good buying opportunity and have the courage to move forward with their acquisition strategies.

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