Litigation

The Risks of a Conflicted CEO

Third parties want the CEO to be involved in a sale or merger. What can the board do to ensure self-interest does not taint the negotiation process?

By Lewis H. Lazarus and Katherine J. Neikirk

Companies face a Catch-22 when a potentially conflicted CEO negotiates a third-party merger transaction. It seems obvious that a company's CEO should have a role in negotiations for a sale or merger of that company with an unrelated third party, since he or she is likely to possess the most knowledge about the company and its prospects. An acquirer is unlikely to be interested in buying a company without speaking to the CEO and may not be interested in the company without the CEO's continued presence. Removing a company's most knowledgeable and potentially skilled negotiator from negotiations and prohibiting a third-party acquirer from communicating with the CEO until a transaction is finalized is impractical and undesirable.

Allowing a conflicted CEO to negotiate a transaction with insufficient board oversight exposes the company, its CEO, and its directors to the risk of losing the transaction and increasing litigation expenses.

Conflicting interests may arise when a CEO's compensation package includes change-in-control payments, a CEO negotiates an employment agreement with an acquirer, or a CEO's retirement package changes as the result of a transaction. A finding that a CEO's self-interests tainted the negotiation process can lead to the issuance of an injunction against the proposed transaction, increased litigation expenses if the corporation is forced to incur the expense of discovery and trial, and liability of the CEO and/or board members for breach of fiduciary duty.

To reduce these risks, CEOs and boards should tread carefully when the CEO participates in negotiating a transaction with a third-party acquirer. CEOs can take precautionary measures by, among other things: promptly informing the board upon receipt of a proposed transaction; informing the board before initiating a sale; disclosing any potential conflicts of interest; and fully cooperating with independent directors and advisors.

Boards can take precautionary measures by, among other things: sufficiently overseeing and, where appropriate, actively participating in the negotiations; creating, when necessary, a special committee to conduct the negotiations; retaining independent advisors; and disclosing to stockholders all material facts, including the nature of the CEO's potentially conflicting interests.

These measures reduce the risk of a successful challenge to a third-party transaction so that it is more likely to close in a timely manner. These measures also make it more likely that a court will defer to the business judgment of the board approving the transaction. This means any litigation challenging the transaction is likely to end earlier, before discovery or trial, which will reduce litigation expenses. Finally, CEOs and boards face less risk of personal liability for breach of fiduciary duty claims based on the challenged transaction.

Allowing a conflicted CEO to negotiate a transaction with insufficient board oversight exposes the company, its CEO, and its directors to the risk of losing the transaction and increasing litigation expenses.

Reduce your risk and your company's risk of a lost transaction and expensive litigation. Next time you negotiate or oversee negotiations of a third-party merger transaction, make sure you are fully informed of the legal ramifications.

Lewis H. Lazarus is a partner and Katherine J. Neikirk is an associate at Morris James LLP in Wilmington, Del., where their practice focuses on corporate and fiduciary litigation.

Reprinted from Directorship magazine October/November 2008. For reprints or to subscribe, email subs@directorship.com or visit www.directorship.com.