Board oversight of major transactions and cybersecurity incident response

Mergers, acquisitions, and divestments are among the most strategically important moves that a company can make. They also represent important tests of the board's relationship with management, its ability to balance strategy and opportunity, and the health of the organization's culture. A major cybersecurity incident represents another kind of test, challenging the ability of management and the board to act quickly and without complete information, and placing a premium on having the right plan in place before a cyber incident occurs.

Members of the Lead Director Network (LDN) met on March 27 in Washington DC to discuss the board's role in overseeing major transactions. In a separate session, members discussed the board's response to a major cybersecurity incident, joined by Phyllis Sumner, a litigation partner at King & Spalding and leader of the firm's Data Privacy and Security Practice, and Richard Walker, a partner in King & Spalding's Government Matters Group and former SEC Director of Enforcement and General Counsel.

Board oversight of major transactions

One year ago, political and economic uncertainty contributed to declining mergers and acquisitions (M&A) activity, with the number of deals globally at a 20-year low for the first part of 2017.[1] However, transaction volume accelerated in the final quarter of the year, and 2017 was the fifth most active year on record in terms of transaction volume, according to JPMorgan's annual M&A review.[2] Individual transactions have attracted a lot of attention, including industry consolidation plays like United Technologies' acquisition of Rockwell Collins or Broadcom's failed bid for Qualcomm (which in turn spawned rumors that Intel would acquire Broadcom). Cross-sector acquisitions, such as Amazon's $14 billion acquisition of Whole Foods and CVS's $69 billion bid for Aetna, have also loomed large. Analysts expect the number and size of transactions to increase this year, driven by an improving economy and tax reform in the United States.[3] As a result, transactions remain a crucial part of corporate strategy and an important aspect of the board's oversight responsibilities.

Several aspects of effective board oversight of transactions emerged from the discussion with LDN members:

- Engage early on significant deals
- Foster a culture of openness and candor between the board and management
- Balance strategy, changing conditions, and organizational capacity to deliver
- Pay particular attention to "mergers of equals"
- Be willing to say "no" to a transaction

Engage early on significant transactions

While the board is always informed of acquisitions, certain types of transactions require earlier and deeper involvement. *"With a plain-Jane deal, the board has to sign off, but once it's happening, management runs the deal without a lot of supervision, as long as it stays within the box. Bolt-on acquisitions in the core business—not transformational; divestment of non-core assets that are best to monetize—no need to get into the weeds."* Large, complex, acquisitions that are transformational to the business, however, require board attention throughout the process of evaluating and negotiating the deal.

The board's ability to scrutinize potential transactions can be hindered if it is not brought in early enough. Members noted that management teams often present the board with a deal at an advanced stage of planning, with one acknowledging that *"by the time a deal got to board, it was over, it was done. We were just looking for the board's blessing."* Members agreed that, while this might often be the case, approaching a transaction in this way is not a good process and that failing to get the board involved early can threaten to scuttle even acquisitions that make strategic and financial sense.

Foster a culture of openness and candor between the board and management

Regardless of when the board engages, members suggested that management often presents an overly optimistic analysis of the merits of a deal. As a result, LDN members stressed the need for the board to probe the analysis, work hard to solicit dissenting views, and make sure potential deals are thoroughly critiqued. This can be a challenge if management is unwilling to expose the potential risks of the deal or if the CEO is reluctant to allow dissenting views to come to the board. In addition, some members suggested that board members might be reluctant to challenge the CEO, although most agreed that boards are generally less deferential to CEOs than in the past.

The ability of a board to surface dissenting views and generate a robust conversation can be a sign of the strength of corporate culture. One member recalled that on one major transaction *"one member of the management team had a different view. The CEO made sure that the* *board heard directly from that person; he wanted that dialogue to actually happen …* that *doesn't happen because of the deal but because of the culture in the company. So many companies operate with the mindset that you come in with something polished and view confrontation with the board and different points of view as a negative."* Other companies operate with a more open culture, with one member expressing *"the biggest risk mitigation factor for a transaction is having an open culture in the company."* Another member agreed, *"The culture apart from any acquisition is the key thing, and the board has to do the work to maintain a healthy culture."*

Members noted the importance of challenging even the most strong-willed CEOs, with one member pointing out that failing to do so is *"how a lot of imperial CEOs happen. It is important to get the CEO used to the fact that the board's job is to ask questions. If you can create that culture early on, the CEO can get used to it and everyone gets comfortable."* Another member reported having *"lived through the situation of saying 'no' to a deal to an imperial CEO—we thought he was going to quit. The management team was angry, but he was an adult, and lived with the outcome."*

Balance strategy, changing conditions, and organizational capacity to deliver

Growth through acquisition is a strategic option for many large companies. Indeed, members noted that exploring potential transactions is—or should be—an ongoing aspect of strategic planning. One member said, *"Larger, well-managed companies get bankers coming in with ideas all the time, but it's folded into the planning. There are two or three deals that could be pursued at any time. In large companies, M&A aspects of strategy are there constantly."* Another member added, *"The really important thing is that the relative priority and importance of a potential deal is put in the context of the whole by looking at enterprise opportunity and enterprise valuation. The board needs to have sense of whether a deal is advancing a business strategy or an enterprise strategy."*

Balancing strategy and opportunity

One member described the relationship between strategy and M&A this way: *"You start with a collective understanding of the greatest value creation opportunity. Then you develop pipelines for categories and for each business."* However, while members cautioned against the impulse to do deals just because they are available, one member noted, *"acquisitions are also based on opportunity—you can decide that something makes sense because it is available."* Such deals call for added caution, however: *"the opportunistic deal is one you have to scrutinize—that can be a board's toughest challenge."*

Boards and lead directors play a key role in balancing strategic considerations with opportunities and changing conditions: *"We can set a strategy and follow a course, but circumstances change, and you have to be willing to change direction. You have to be able to recognize when conditions have changed and your strategy should change along with it.*

Boards can and should drive that." Another member noted, *"You don't control when and whether opportunities are going to happen. When you are faced with something that could happen, the important thing is how you keep that larger strategic conversation in mind, and ask what the deal will enable and what will it preclude. Will it advance your enterprise strategy?"*

At the same time, boards must also ensure that management is devoting resources to the strategic priorities they've identified. One member noted that their board had seen *"a lot of disconnect between M&A and enterprise strategy. Management was not putting the money where we said we wanted it to go."* This was partly the result of management being *"so busy protecting today's earnings."* In that situation, the board may need to push management to align investments with long-term strategy: *"Boards have to say, this is the shot you called, but it doesn't look like you are really behind it. The board has to keep pressing and pressing."*

Assessing the organizational capacity to execute

Even deals that are available and present strategic opportunities can fail if management and the board lack the capacity to execute them successfully. A member highlighted the importance of being realistic about a company's capabilities to execute the transaction: *"One of the roles of board members is to assess whether you have the competencies to pull something off. Companies sometimes underestimate how hard it is to pull off."*

This is particularly true if a company has engaged in a series of transactions. Members acknowledged that deal fatigue for both the board and management can be a real and significant issue: *"Does management have the stamina to integrate the acquisition and not stumble? That's what keeps you awake at night."* Another member pointed out, *"Even if the acquisition target is part of the strategy, if the acquiring entity doesn't have the capacity, if there is fatigue, and you are still trying to complete one acquisition, and another one comes along, it can be a real disaster, because there is no capacity, and fatigue in the organization, so you can't get it done."*

Pay particular attention to "mergers of equals"

Members acknowledged that transactions involving two firms of relatively equal size entail additional complications and are among the most challenging transactions. When neither party clearly dominates, issues of roles and relative status ("social issues") can emerge, forcing the board to engage more actively. A member said, *"The most difficult transaction has always been a merger of equals. There are so many social issues, shareholder issues, etc. Spinoffs and acquiring businesses are smoother because you are in the driver's seat."*

In recent history, mergers of equals have represented a disproportionate number of struggling or failed transactions, including: Traveler's Group and Citicorp; Viacom and CBS; Daimler-Benz and Chrysler; Dean Witter and Morgan Stanley; and AOL and Time Warner.[4]

One member who had been through a merger of equals pointed to the challenges, saying, *"It was only going to work if the two CEOs were going to click and make this happen."* The member also emphasized the difficulty of *"integrating two very different board cultures,"* since in that case both predecessor firms had equal representation on the new entity's.

Members differed on the best way to construct a new board and management team in a merger of equals. One member who had experienced a genuine and successful merger of equals noted that the new entity had included equal representation from the predecessor boards and had equally divided committee leadership to *"grow one culture"* on the new board. Another said, *"There may be a horizontal deal—but you can't have an 'even-steven' board."*

At the management level, members noted that frictions are eased if one CEO is an obvious choice to lead the new company and the other is ready to retire or step down for other reasons. In the absence of such a situation, clarity around who will run the combined company is paramount. One member said, *"At the end of the day, you have to pick a CEO with the power to run the business, and the power to pick the rest of the management team."* Even in a horizontal merger, *"Somebody has to come out ahead and the shareholders on the other side get a premium. Someone has to have control; otherwise it's chaos."*

Members emphasized the importance of picking the best leaders from both predecessor companies. In a merger of equals, the temptation can be to resort to what one member called a *"Noah's ark"* approach, picking equal numbers from each of the management teams. The member observed that such an approach rarely works; rather *"it has to be 'best athlete."* Another noted that their board had learned through experience in making several major acquisitions that they needed to adjust their assumption that top executive leadership would come from the acquiring firm; in the past, the member said, the firm *"would claim to take the best athlete, but the best athlete was always* [from our company], *and we discovered that didn't work. We have begun to recognize good players on other teams."*

Calling it a "merger of equals"

It is often the case that transactions billed as mergers of equals turn out to be acquisitions, with one of the firms clearly the dominant party. Identifying a transaction as a merger of equals can reduce the premium buyers have to pay, with one study showing that the average premium on transactions labeled mergers of equals was less than half that of other transactions. For sellers, it can make a transaction seem less threatening.[5] One high-profile example was the merger of Daimler and Chrysler in 1998 to create DaimlerChrysler. Billed as a merger of equals, it soon became clear that Daimler was the dominant partner. Daimler Chairman Jurgen Schremp later acknowledged that it had been labeled a merger of equals for

Calling it a "merger of equals"

what he called "psychological reasons": to make the deal more palatable to Chrysler stakeholders.[6]

One LDN member recalled a similar dynamic, where the board considered calling a transaction a merger of equals, *"but it wasn't really. But the management teams had been conscious that both sides had to win. The idea is to feel inclusive, but not try to say it's an equal merger. We needed to be direct and say, 'we are acquiring you, but we are hoping to build a collective culture.'"*

Some LDN members argued that a true merger of equals is exceedingly rare. One commented that *"it's almost never the case"* that the two parties are genuinely equals. Indeed, in 2001 the Financial Accounting Standards Board concluded that "virtually all business combinations are acquisitions" and ended the ability to combine two firms in a merger of equals in accounting terms.[7] Accounting technicalities notwithstanding, mergers of equals have persisted; there were some 300 transactions identified as mergers of equals between 2001 and 2014.[8]

Be willing to say "no" to a transaction

Members agreed that one of the most important roles the board can play is to say "no" to a deal in the face of management enthusiasm. One member said, *"The best deal I ever did is the one I didn't do. Management says, I've got to have this; I've got to get this thing done. So sometimes you say 'you've got to stop.'"* Another member agreed, *"Sometimes the board's role is to say 'no.' Sometimes that's the biggest value-producing thing you can do."*

The ability to pull back—even after a great deal of work has been done—is important. One member recalled a deal that was ultimately completed only after a long period of regulatory delay and ultimately proved to be detrimental to the acquiring firm. The member recalled, *"I saw something during that deal: everyone had done so much work, that they got stuck into saying, 'We have to have this.' By the time it became available, it was not a good thing; the company was not prepared to integrate it. Those long drawn-out things are such that, unless it's so strategic, one should just walk away."* In contrast, one member recalled a situation where a firm pulled out of a deal when the price got too high, even though it had identified that deal as an important strategic acquisition: *"The board and management came to agreement to say 'no' to that deal, which was the right thing to do."* The member noted that the acquisition eventually became a significant burden to the rival firm that had outbid them. In contrast, *"[b]y not doing it, we were able to move in other directions. We had the determination to recognize that the strategy can change, that you have to be clear sighted enough to recognize that saying 'no' can be the most important decision."*

The board's oversight of cybersecurity incident response

With data breaches, ransomware attacks, and the malicious interventions of state actors constantly in the news, cybersecurity remains at or near the top of almost every board's list of major risks. The threat is constantly expanding. McAfee Labs recorded an average of eight new samples of malicious software every second in the fourth quarter of 2017, and the total number of malware samples had risen to nearly 700 million by the end of the year. Ransomware alone was up nearly 59% in 2017.[9]

The evolving threat landscape means that boards and senior management teams must be prepared to respond to a cyber incident. Ms. Sumner emphasized the need for the board to view the firm's cybersecurity program at an enterprise level, focusing on key risks, and understanding the landscape of the organization and its particular risk exposure. Boards should also ensure that there is sufficient communication and accountability, so that management understands and meets the board's expectations.

Members pointed out that the early moments of an incident are crucial, and in those moments information is scarce, making preparedness critical. As one member put it, *"Judgments made in the early days before you have answers can really affect how it plays out. So the board and management need to decide what your plan is."*

In discussing the board's role in responding to a cybersecurity incident, members identified two major sets of issues that a response plan needs to address: communication within the organization and between management and the board about the incident; and whether, when, and how to disclose a cyber incident publicly.

Communication within the organization

Ms. Sumner emphasized that management and the board *"need to have a policy in place so it is clear to management what … the board's expectations [are]"* including *"an escalation policy outlining scenarios of what immediately should be brought to the board."* One member agreed, *"How to figure out how to separate trivial from material is where you start the process."* Another member, citing the possibility of public disclosure, said that in the case of a suspected ransomware attack, *"I think the board ought to be notified immediately, even before we know it's true. Because there could be a headline in the paper tomorrow."* Another suggested that *"the earlier management is in contact with leadership of the board—at least the lead director, audit committee chair, and any cyber expert on the board—the better off everyone is."*

Ms. Sumner pointed out that organizations vary significantly in the nature and frequency of attacks they face, so board expectations about the timing and extent of their involvement with cybersecurity response should also vary accordingly. She suggested that it might be appropriate for the management to say, *"Maybe we evaluate whether this is real before we tell the board. If you are a company that receives attacks on a regular basis, you don't want to be* *informed as a board of every possible or potential threat. You need an incident response plan that is appropriate to the firm."*

Members pointed out that executives and management teams are often reluctant to inform the board in the absence of all the facts or answers, noting a tendency to *"circle the wagons"* in the face of an incident. Ms. Sumner recalled an incident *"where the security team interacted with the Secret Service about an insider threat for two months and did not contact legal, executives, or the board about the threat.*" She continued that this underscored the need for a plan where *"the trigger points are clear to those on the front line who are receiving the initial threat information."*

Even where expectations are clear, senior management may be reluctant to share information with the board. One member recalled instances *"where important information didn't get to [the] board because people thought they should have the answers, and when info got to [the] board it was too late."* In response, said one member, *"Boards need to give management permission to not have all the answers when they come to us. We need to be explicit about that, because management always thinks they need to have the answers. A board needs to build that level of trust with management."* Another agreed, *"You need have a culture that says, give me good, bad, and ugly sooner rather than later."*

Disclosure considerations

The timing and pace of disclosure is an important consideration that should be a part of board planning. Several members advocated for early and full disclosure of cyber incidents to regulators, customers, and the public, citing the likely reputational harm resulting from delay. Referring to one prominent data breach, one member said that if they had disclosed immediately, *"they would not have a fraction of the problems they have now.*" One member said that at their company, *"Disclosures are instant to the board and all of our customers, and there soon comes a point when we go public."*

Ms. Sumner pointed out that after Target was criticized for going too fast and issuing incorrect information when it suffered a data breach in 2013, a trend emerged for firms to slow down public disclosure to ensure accurate information. In the wake of criticism faced by companies in recent high-profile breaches that they were too slow to disclose their data breaches, she said, that trend is reversing and *"everyone is saying we've got to disclose immediately."*

In regulation, the trend is toward earlier and fuller disclosure as well. In the European Union, the General Data Protection Regulation (GDPR), which goes into effect this month, imposes a 72-hour mandatory notification requirement for cases where a breach is likely to "result in a risk for the rights and freedoms of individuals."[10] In the US, the New York Department of Financial Services, often a bellwether for financial services regulation, recently mandated a similar notification requirement for covered entities. Finally, Mr. Walker pointed out that the Securities and Exchange Commission issued new guidance in early 2018, calling for more robust disclosure of cyber incidents and cyber risk, including linking the process of breach or incident response with the disclosure controls that address other aspects of material information.

One member noted that there are downsides to both approaches, saying that *"you don't know whether going fast or not will be a bad outcome,"* and noting that one problem of disclosing early is the risk of releasing incorrect information that subsequently has to be revised. So the question is, *"if you go early, how do you bring the public along in a way that shows that our goal is to be transparent, but we don't know all the information yet. The key is to pace it in a way so you are not undermining trust."* While acknowledging the risks of both approaches, one member said, *"I'd rather defend going out early … than waiting."*

However, there is a range of considerations that might argue for delaying disclosure:

- **Added legal exposure.** Ms. Sumner noted that there are *"risks inherent in early disclosure. Once the information goes out, you can't bring it back, you lose control of it, and it goes out to a wide variety of stakeholders. When you disclose, you are in the position of being a victim of a crime and at the same time a target for regulators, state attorneys general, and a very aggressive plaintiff's bar."*
- **Unnecessary reputational harm**. Ms. Sumner noted that *"A very small percentage of data breaches ever go public; it would have inflicted significant brand damage if they had made a public statement."* Indeed, despite the hundreds of millions of examples of malicious software and the constant threat of cyberattacks, there were only about 1,100 publicly disclosed security incidents worldwide in 2017. [11]
- **Increasing risk exposure.** Mr. Walker noted that public disclosure of a cybersecurity incident entailed an additional risk: *"once you let people know of a breach, especially if you don't have it solved, you advertise a weakness, and a bad situation could be made worse."* Ms. Sumner pointed out that the SEC, itself a victim of a recent data breach, and other government agencies take the time to shore up their defenses before they go public with a security breach.
- **Requests from law enforcement**. Law enforcement may want firms to delay disclosure so they can carry out an investigation, as Ms. Sumner posed the question: *"Suppose you reach out to law enforcement and they don't want you to disclose because they want to investigate?"* The choice of whether to comply can be a difficult one, she noted, and it may not always be in the interest of the firm to comply.

In closing, Ms. Sumner identified several concrete steps that boards can take to improve their cybersecurity readiness: establish clear roles for the board and its committees; set clear expectations about the cybersecurity information that the board and its committees expect to receive from management; maintain adequate access to both internal and external cybersecurity expertise, with regular discussions about cyber risk management; and put policies and procedures in place to deploy in the event of a potential breach. Overall, she emphasized that it is important for boards to approach cybersecurity as an enterprise risk management issue, which includes assessing not only the cybersecurity risks and threats the company faces but its cyber security strategy, plan, system infrastructure, culture, talent, training, and budget.

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairs drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

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Appendix: meeting participants

The following Lead Director Network members participated in the meeting:

Bobby Burchfield, Partner, King & Spalding

Dave Calhoun, Independent Chair, Caterpillar

Loren Carroll, Non-Executive Chair, KBR

Sandy Cloud, Lead Trustee, Eversource Energy

Don Cornwell, Lead Director, Avon

Ann Hackett, Lead Director, Capital One Financial Corporation

Dixie Johnson, Partner, King & Spalding

Doug Johnson, Lead Director, Aflac

Linda Fayne Levinson, Lead Director, Jacobs Engineering Group

Jim Nevels, Lead Director, WestRock

Cal Smith, Partner, King & Spalding

Doug Steenland, Non-Executive Chair, AIG and Performance Food Group

Larry Thompson, Lead Director, Southern Company

Dick Walker, Partner, King & Spalding

Endnotes

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