Director Notes

Effects of M&A Litigation

by C.N.V. Krishnan, Ronald W. Masulis, Randall S. Thomas, and Robert B. Thompson

Mergers and acquisitions offers are frequently subject to litigation, particularly class action lawsuits brought by shareholders against the boards of directors of target companies. This report documents the types of lawsuits triggered by M&A offers, their impact on offer completion rates and takeover premiums, and the factors that lead to positive lawsuit settlement outcomes. The results of the analysis show that predeal litigation raises the expected takeover premium received by target company shareholders, more than offsetting the expected fall in the deal completion probability, generating an overall net benefit for target shareholders.

Mergers and acquisitions (M&A) offers that are subject to lawsuits are completed at a significantly lower rate than offers that are not subject to litigation.* However, litigation significantly increases the takeover premium in deals that are completed. Economically, the expected rise in the takeover premium more than offsets the fall in the probability of deal completion, so there is a rise in the expected takeover premium paid in offers that are subject to predeal-completion litigation.

In an M&A context, shareholders frequently sue target boards of directors in class action lawsuits, alleging that directors breached their fiduciary duties to their shareholders by agreeing to sell the company for too low a price. Alternatively, a bidder may file a case claiming that a target's board of directors refused to sell the company at an advantageous price, therefore breaching its fiduciary duties to shareholders. A target company can also sue, alleging that a bidder violated federal or state corporate law and thus should have its bid enjoined by the courts. Occasionally, the government sues on antitrust or other grounds.

Shareholder lawsuits form the vast majority of all lawsuits. Suits challenging controlling shareholder squeeze-outs are significantly more likely to lead to settlement and the payment of cash settlements. Not surprisingly, target lawsuits are significantly associated with higher takeover premium in completed deals.

* This Director Notes is based on a longer paper by the same authors, "Litigation in Mergers and Acquisitions," Vanderbilt Law and Economics Research Paper, No. 10-37, December 9, 2010 papers.ssrn.com/sol3/papers.cfm?abstract_id=1722227

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Methodology

This report examines litigation in M&A offers announced during a representative period of 1999–2000. The data set was constructed in two stages. First, we collected all M&A litigation filed in the Delaware Chancery Court during 1999 and 2000.[1] Second, we expanded the data set to include all federal and other state court litigation challenging M&A transactions. In addition to other filings, we searched all target (and if necessary bidder) Form 10-K, Form 10-Q, Form 8-K, Form S-1, Schedule 14A, Schedule 14D9, and Schedule TO for each merger and acquisition transaction that occurred during the 1999–2000 sample period. (For definitions of the variables, see "M&A Offer Outcomes: Components of the Multivariate Analysis" on page 3.)

In the initial sample of 373 litigation cases, about 88 percent are class action suits, 4 percent are derivative suits, and many of the remaining cases are individual action lawsuits. About 52 percent of the cases are Delaware suits, 38 percent are from in other states' courts, and 10 percent are federal suits. The vast majority of the lawsuits (over 95 percent) were filed before the offer was completed. The number of bidder and target lawsuits is relatively small (about 5 percent and 2 percent, respectively, of all lawsuits). Information on whether lawsuits were settled or dismissed is available for 338 of the 373 cases. (In the remainder, either the plaintiff or the defendant won or no outcome information is available.) For the 338 lawsuits that were settled or dismissed, about one-third were settled with some benefit to target shareholders, the bidder, the target, or the plaintiffs' attorneys. The proportion is similar for both years. The remaining cases were dismissed with no payment.

Each lawsuit is associated with an M&A offer (and its features) in Thomson Financial's SDC Mergers and Acquisitions database. After including nonlitigation offers that satisfy all our data requirements, 2,512 distinct offers were announced during our 1999–2000 sample period, of which 299 attracted litigation. In the overall sample, about 80 percent of the offers were successfully completed at an average premium of roughly 38 percent above the stock price one week before the offer, and the average offer size is $1.12 billion. These descriptive statistics are not significantly different across the two years. There are far fewer federal suits than state court cases, but the former entailed a significantly higher proportion of bidder and target firm suits. In fact, there are no target lawsuits in the Delaware cases included in the sample. In comparison, a large proportion of cases filed in state courts are class actions. Overall, more than 42 percent of settled cases involved the payments of monetary awards or increased consideration paid to target shareholders in the transaction. Lawsuit settlement rates are not significantly different for Delaware and federal court cases. However, the proportion of cash settlements is significantly higher for suits settled by Delaware courts compared to those in other state courts (noncash settlements often involve increased disclosure to shareholders concerning the transaction). A significantly higher proportion of deals litigated in state courts are completed, compared to cases brought in federal court. This suggests that litigation pursued in state courts (including Delaware) may be less of an obstacle to deal completion than litigation pursued in federal court. Also, takeover premiums in completed deals are significantly lower when litigation is pursued in state courts compared to federal court, suggesting less pressure on bidders to raise the deal premium in state court cases. The proportion of settlements that result in cash payments to shareholders is significantly higher in lawsuits challenging controlling shareholder squeeze-outs, indicating that target shareholders more frequently benefit from litigation in these cases. Courts analyze controlling shareholder transactions using the demanding judicial scrutiny applied in conflict of interest transactions. Also, the deal completion rate is much higher, perhaps reflecting that a controlling shareholder can unilaterally ensure that a deal is completed by having the controlled target's board of directors propose a merger transaction and then voting its controlling share interest in favor of it.

Although there are far fewer bidder and target lawsuits in the sample, these cases do have some interesting features. These lawsuits have significantly lower rates of settlements than other types of lawsuits, but they tend to have higher takeover premiums in completed deals. Bidder lawsuits are typically filed in an effort to remove a target's takeover defenses. Therefore, settlements in bidder lawsuits occur when an initially hostile transaction turns into a friendly deal, and the target company is acquired, generally at a higher takeover premium. In contrast, target company suits are usually designed to block an unwanted transaction or to force a higher bid premium. If they are successful, the bidder drops its offer and the litigation is dismissed. Thus, it is not surprising that none of the target lawsuits are settled in court and, if the deal is completed, it is done at a higher takeover premium.

1 See Robert B. Thompson and Randall S. Thomas, "The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions," *Vanderbilt Law Review* 57, no. 1, January 2004, p. 133, for a fuller description of the Delaware data collection process.

M&A Offers Outcomes: Components of the Multivariate Analysis

To control for self-selection where litigation is associated with certain deal outcomes simply because it occurs more frequently in certain types of offers where the observed outcomes are more likely, Tables 1A and 1B report the regression coefficients and associated z-statistics (and t-statistics) that are based on heteroskedasticity-consistent industry-clustered standard errors for an Instrumental Variable (IV) model using the limited information maximum likelihood (LIML) estimation approach, where **Pretransaction Litigation** is the endogenous covariate instrumented with ***Offer Size,*** the value of the transaction (in $ bn), which is the total value of consideration paid by the acquirer for the target, excluding fees and expenses. Also reported are the number of M&A offers over which each regression specification is run. Included in the regressions as controls are β_Y, a vector of year fixed effects, and β_I, a vector of bidder industry fixed effects.

Completed Offer is an indicator variable that takes the value of 1 for withdrawn acquisition offers and 0 otherwise.

Takeover Premium is the price per share paid by an acquirer in completed deals for a public target firm's shares relative to the target's stock price one week prior to the announcement date as per the Thomson Financial Mergers and Corporate Transactions database.

Top Bidder (Target) Law Firm is an indicator variable that takes the value of 1 for a law firm that is in the top 10 annual league table rankings of bidder (target) legal advisors based on the value of M&A offers that a bidder (target) legal advisor advised on. Each law firm is given full credit for each offer for which it provides advisory services. League tables are separately calculated for bidder and target financial and legal advisers.

Top Bidder (Target) Investment Bank is an indicator variable that takes the value of 1 for an investment bank that is in the top 10 annual league table rankings of bidder (target) financial advisors based on the value of M&A offers that a bidder (target) financial advisor advised on. Each investment bank is given full credit for each offer for which it provides advisory services. League tables are separately calculated for bidder and target financial and legal advisers.

Delaware Suits is an indicator variable for Delaware cases.

Target Suit is an indicator variable for litigation initiated by the target firm.

Bidder Suit is an indicator variable for litigation initiated by the bidder firm.

Intra-Industry Offer is an indicator variable that takes the value of 1 when the bidder and target firms are from the same industry (using the two-digit SIC code) and 0 otherwise.

Hostile Offer is an indicator variable set equal to 1 for hostile bids and 0 otherwise.

Multiple-Bidder Offer is an indicator variable set equal to 1 for offers involving competing bidders and 0 otherwise.

Controlling Shareholder Squeeze-out is an indicator variable set equal to 1 for offers where a bidder had a toehold of 50 percent or more in the target firm before the announcement date, and 0 otherwise. *Bidder Minority Stake* is an indicator variable set equal to 1 for offers where a bidder had a toehold of 5 percent or more, but less than 50 percent, in the target firm before the announcement date, and 0 otherwise.

Stock Financing is the percentage of the total offer that is in stock.

Tender Offer is an indicator variable set equal to 1 for tender offers, and 0 otherwise.

Target Termination Fee is an indicator variable set equal to 1 for offers with a termination fee provision payable by target firms to bidders, and 0 otherwise.

M&A Offers Outcomes: Offer Completion Rate

We report the regression coefficients and associated *z*-statistics (in parenthesis) based on heteroskedasticity-consistent standard errors adjusted for industry clustering for the following Instrumental Variable (IV) model using limited information maximum likelihood (LIML) estimation (to control for selection bias),[a] where *Pretransaction Litigation,* litigation that arises before a deal closes, is the endogenous covariate.[b]

$$\begin{aligned} \textit{Completed} = \; & \beta_Y + \beta_I + \beta_1 \textit{ Top Target Law Firm} + \beta_2 \textit{ Top Bidder Law Firm} + \\ & \beta_3 \textit{ Top Target Bank} + \beta_4 \textit{ Top Bidder Bank} + \\ & \beta_5 \textit{ Pretransaction Litigation} + \beta_6 \textit{ Intra-Industry Offer} + \\ & \beta_7 \textit{ Hostile Offer} + \beta_8 \textit{ Multiple-Bidder Offer} + \\ & \beta_9 \textit{ Controlling Shareholder Squeeze-out} + \beta_{10} \textit{ Bidder Minority Stake} + \\ & \beta_{11} \textit{ Stock Financing} + \beta_{12} \textit{ Target Termination Fee} + \beta_{13} \textit{ Tender Offer} + \\ & \beta_{14} \textit{ Delaware Suit} + \beta_{15} \textit{ Target Suit} + \beta_{16} \textit{ Bidder Suit} + \varepsilon. \end{aligned}$$

Pretransaction litigation is instrumented with offer size, because it is significantly and positively related to litigation.

[a] For more information, see Jennifer L. Juergens, and Laura Lindsey, "Getting Out Early: An Analysis of Market Making Activity at the Recommending Analyst's Firm," Journal of Finance 64, no. 5, 2009, pp. 2,327-2,359; C.N.V. Krishnan, Vladimir I. Ivanov, Ronald W. Masulis, and Ajai K. Singh, "Venture capital reputation, post-IPO performance and corporate governance," Journal of Financial and Quantitative Analysis (forthcoming); C.N.V. Krishnan and Ronald W. Masulis, "Law Firm Reputation and Mergers and Acquisitions," Vanderbilt University Working Paper Series, 2010 (papers.ssrn.com/sol3/papers.cfm?abstract_id=1443384).

[b] C.N.V. Krishnan, Ronald W. Masulis, Randall S. Thomas, and Robert B. Thompson, "Litigation in Mergers and Acquisitions," Vanderbilt Law and Economics Research Paper, No. 10-37, December 9, 2010, at papers.ssrn.com/sol3/papers.cfm?abstract_id=1722227.

Finally, we note that the sample includes far more class actions than derivative cases. As Thompson and Thomas noted, shareholders prefer to bring class actions to challenge M&A transactions because they do not need to overcome the additional procedural barriers raised in derivative suits.[2] The other differences between the two types of shareholder suits are not statistically significant.

As Table 1A shows, the size of the M&A offer is an indicator of the complexity of the transaction, as larger transactions may involve valuing multiple divisions leading to a higher likelihood of disputes in valuations.[3] This can entail negative announcement-period bidder stock price effects, reflecting bidder shareholder anxiety about the value consequences of the deal.[4] Larger deals are also economically more important deals, often reflecting a bidder management's empire building motives and an increase in potential fees for plaintiffs' lawyers. For all of these reasons, there is a higher probability of litigation in such bids.

The first column of Table 1A reports the results of a shorter regression specification that includes only legal and financial advisor reputations as control variables. We find that top target law firms and pretransaction litigation are both associated with a significantly higher probability of deal failure, whereas top bidder law firms and both top target and bidder investment banks are associated with a significantly higher probability of deal completion relative to other less prominent advisors.[5] This evidence is consistent with the claim that top investment banks and top bidder law firms try to ensure that deals are completed and they receive their fees, whereas top target law firms try to stop some hostile offers from being completed. Importantly, litigation also creates significant risks of noncompletion of the transaction. The second column reports the results of the full model. It shows that the associations uncovered by the simple model continue to

2 Thompson and Thomas, "The New Look of Shareholder Litigation," p. 133.

3 Henri Servaes and Marc Zenner, "The role of investment banks in acquisitions," *Review of Financial Studies* 9, no. 3, 1996, pp. 787–815.

4 C.N.V. Krishnan and Ronald W. Masulis , "Law Firm Reputation and Mergers and Acquisitions," Vanderbilt University Working Paper Series, 2010.

5 Raghavendra Rau, "Investment bank market-share, Contingent fee payments and the performance of acquiring firms," *Journal of Financial Economics* 56, no. 2, 2000, pp. 293–324.

hold, even after controlling for other offer characteristics. Because shareholder suits form the vast majority of all suits and we have controlled for bidder and target suits, the interpretation of the *Pretransaction Litigation* coefficient is that shareholder litigation is associated with a higher probability of deal failure.

The signs on the control variables are as expected, namely intra-industry offers are associated with a higher probability of deal completion, while the deal complexity variables—hostile bids and multiple-bidder offers—are associated with a lower probability of deal completion. In line with the results of other research, offers that have target termination fee provisions and tender offers are associated with a higher probability of deal success.[6] Two additional litigation features—indicator variables for whether the suit is filed in Delaware and is a bidder suit or a target suit—as well as bidder pre-offer equity stake are not significantly associated with the probability of deal completion.

Table 1B reports the results of the regression specification that includes only the pretransaction litigation indicator and legal and financial advisor reputations. Top target law firms and pretransaction litigation are both associated with a significantly higher takeover premium in completed deals. This is consistent with the claims that top tier target law firms are successful in employing defensive strategies on behalf of their clients that raise the price bidders must pay to acquire target companies and that litigation raises deal premium in completed transactions. Other top-tier advisors are not associated with significantly higher takeover premia.

Column 2 in Table 1B shows that the associations in Column 1 continue to hold, even after controlling for other offer characteristics. Top target law firms and pretransaction litigation continue to be associated with a significantly higher takeover premium in completed deals. Because shareholder suits form the vast majority of all suits, and we have controlled for bidder and target suits, we interpret the results in the second column of the table to show that shareholder litigation is associated with higher takeover premium in completed deals.

6 Micah S. Officer, "Termination Fees in Mergers and Acquisitions," *Journal of Financial Economics* 69, no. 3, 2003, pp. 431–467.

Table 1A

M&A Offers Outcomes: Offer Completion Rate

Dependant Variable: *Completed Offer*

	(1)	(2)
β_Y	Yes	Yes
β_I	Yes	Yes
Top Target Law firm	-0.33**	-0.31**
	(-2.19)	(-2.04)
Pre-transaction Litigation	-0.70***	-0.71***
	(-4.36)	(-3.46)
Top Bidder Law firm	0.72***	0.69***
	(4.55)	(3.58)
Top Target Investment bank	0.89***	0.58***
	(5.04)	(2.81)
Top Bidder Investment Bank	0.49***	0.62***
	(3.12)	(3.31)
Intra-Industry Offer		0.45***
		(3.62)
Hostile Offer		-2.87***
		(-4.19)
Multiple-Bidder Offer		-2.23***
		(-3.69)
Controlling Shareholder Squeeze-out		0.35
		(1.05)
Bidder Minority Stake		-0.29
		(-1.50)
Stock Financing		-0.01
		(-1.16)
Target Termination Fee		1.02***
		(3.14)
Tender Offer		1.32**
		(2.52)
Delaware Suits		0.08
		(0.67)
Target Suits		-1.45
		(-0.73)
Bidder Suits		-0.84
		(-0.90)
N	2512	2512
Pseudo R^2 (%)	4.36	19.37

*, **, *** denote significantly different from zero at the 10, 5 and 1 percent level respectively.

M&A Offers Outcomes: Takeover Premium in Completed Deals

Table 1B reports the regression coefficients and associated *t*-statistics (in parenthesis) based on heteroskedasticity-consistent industry-clustered standard errors for the following IV model using limited information maximum likelihood (LIML) estimation, where *Pretransaction Litigation* is again the endogenous covariate:

$$\begin{aligned} \textit{Takeover Premium} = \; & \beta_Y + \beta_I + \beta_1 \textit{Top Target Law Firm} + \beta_2 \textit{Top Bidder Law Firm} + \\ & \beta_3 \textit{Top Target Bank} + \beta_4 \textit{Top Bidder Bank} + \\ & \beta_5 \textit{Pretransaction Litigation} + \beta_6 \textit{Intra-Industry Offer} + \\ & \beta_7 \textit{Hostile Offer} + \beta_8 \textit{Multiple-Bidder Offer} + \\ & \beta_9 \textit{Controlling Shareholder Squeeze-out} + \beta_{10} \textit{Bidder Minority Stake} + \\ & \beta_{11} \textit{Stock Financing} + \beta_{12} \textit{Target Termination Fee} + \beta_{13} \textit{Tender Offer} + \\ & \beta_{14} \textit{Delaware Suit} + \beta_{15} \textit{Target Suit} + \beta_{16} \textit{Bidder Suit} + \varepsilon. \end{aligned}$$

where Takeover Premium is the premium paid for target stock in completed deals relative to the stock's price one week prior to the M&A announcement date.

Among the control variables, multiple-bidder offers, because of their competitive nature, and controlling shareholder stakes, because of the stronger legal position of minority shareholder claims in such offers, are both associated with significantly higher takeover premia in completed deals. In line with the results reported by Micah S. Officer, we find offers with target termination fees and tender offers are associated with significant higher takeover premia.[7] Target suits are also associated with significantly higher takeover premia, suggesting that litigation is an effective mechanism for pressuring bidders into increasing offer prices.

Examining the economic effects of litigation on deal completion rates and takeover premia, we find that, after controlling for other offer features, the probability of deal completion decreases by 5.78 percent when an M&A offer is subject to litigation. However, and once again controlling for other offer features, the average takeover premium in completed deals increases by 9.02 percent when an M&A offer is subject to litigation. Overall, predeal litigation raises the expected takeover premium by about 0.80 percent, implying that the expected rise in the takeover premium more than offsets the expected fall in the dealcompletion probability.[8] In other words, on average, M&A litigation generates a net benefit for target shareholders.

7 Officer, "Termination Fees in Mergers and Acquisitions."

8 The change in expected takeover premium is given by the change in deal completion probability multiplied by the expected takeover premium, conditional on an M&A offer not being subject to litigation plus the change in expected takeover premium multiplied by the probability of deal completion, conditional on an offer being subject to predeal completion litigation.

Litigation Impact on the Market for Corporate Control

Federal court lawsuits, while representing less of the sample than state court lawsuits, attract a significantly higher proportion of bidder- and target-initiated litigation than state courts. The analysis shows that bidder and target lawsuits have significantly lower rates of settlements than other types of lawsuits, and deals involving target lawsuits have lower completion rates, but higher takeover premiums if completed. Targets filing suit typically want to either kill the deal as originally proposed or obtain a higher premium, which will lead to both a lower completion rate and a higher average premium in completed deals. Both the lawsuit settlement rate and the proportion of settled lawsuits in which cash consideration is paid are higher for lawsuits challenging controlling shareholder squeeze-outs than for management buyouts and other types of offers. This is due to the more plaintiff-friendly legal regime that applies in controlling shareholder squeeze-out situations. Offer completion rates are also highest for controlling shareholder squeeze-out offers relative to other M&A offer types. This is not surprising given that a controlling shareholder can unilaterally ensure that a deal is completed simply by having a target board of directors approve a merger transaction and then voting its control block of shares in favor of the transaction.

To measure the effect of litigation on offer outcomes (i.e. completion rate and premiums in deals that are completed), we control for various deal features. Following Krishnan and Masulis, we also control for M&A legal and financial advisor reputations.[9] Even after controlling for M&A financial and legal advisor reputation, offer features and industry and time fixed effects, as well as for selection bias, offers subject to lawsuits are completed at a significantly lower rate than offers not subject to litigation. Litigation is also associated with a significant increase in takeover premiums for completed deals. Shareholder lawsuits form the vast majority of lawsuits in the sample, supporting the premise that litigation leads to higher bid premiums because bidders often raise their bids in order to respond to target shareholder claims of an unacceptably low offer prices, and thereby increase target shareholder support for the bid.[10] The economic effects of litigation are such that while the probability of deal completion decreases by 5.8 percent, the takeover premium in completed deals increases by about 9 percent after controlling for other offer features. Moreover, the expected rise in the takeover premium more than offsets the fall in the probability of deal completion, raising the expected takeover premium paid in offers that are subject to litigation prior to deal completion.

The results of the analysis demonstrate the importance of considering litigation's impact on the market for corporate control in any empirical research examining the determinants of M&A transaction outcomes. Further research in the area would benefit greatly from improved federal securities law disclosure requirements concerning deal litigation. In particular, the Securities and Exchange Commission should require target firms to disclose all pending litigation in M&A transactions as part of their Schedule 14d-9 filings required in tender offers, and Schedule 14A proxy statement disclosures to shareholders for mergers. Current requirements leave companies the option of not disclosing some cases. Moreover, the SEC should create stronger incentives for compliance with its existing disclosure requirements, as there are many recent corporate disclosures about M&A transactions that provide incomplete information about the litigation cases that they do mention.

9 Krishnan, Masulis, Thomas, and Thompson, "Litigation in Mergers and Acquisitions."

10 Thompson and Thomas, "The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions," p. 133.

Table 1B

M&A Offers Outcomes: Takeover Premium in Completed Deals

Dependant Variable: *Takeover Premium*

	(1)	(2)
β_Y	Yes	Yes
β_I	Yes	Yes
Top Target Law firm	6.00**	5.90**
	(2.22)	(2.03)
Pre-transaction Litigation	6.39**	4.40**
	(2.16)	(2.00)
Top Bidder Law firm	-1.59	-0.24
	(-0.69)	(-0.09)
Top Target Investment bank	-3.46	-3.30
	(-1.47)	(-1.45)
Top Bidder Investment Bank	-2.95	-2.54
	(-1.20)	(-0.98)
Intra-Industry Offer		0.18
		(0.08)
Hostile Offer		-2.87
		(-0.70)
Multiple-Bidder Offer		2.38***
		(2.88)
Controlling Shareholder Squeeze-out		1.47*
		(1.91)
Bidder Minority Stake		-0.64
		(-1.58)
Stock Financing		0.06**
		(2.13)
Target Termination Fee		1.02***
		(3.92)
Tender Offer		0.57*
		(1.76)
Delaware Suits		-1.98
		(-0.91)
Target Suits		4.46***
		(3.51)
Bidder Suits		1.83
		(0.62)
N	1995	1995
Adjusted R^2 (%)	3.76	6.03

*, **, *** denote significantly different from zero at the 10, 5 and 1 percent level respectively.

About the Authors

C.N.V. Krishnan is an associate professor of banking and finance and the Deborah and David Daberko Fellow at Case Western Reserve University's Weatherhead School of Management. His research interests are in the area of corporate finance. His research has been published in leading academic journals including the *Journal of Finance*, and presented at top academic conferences, including the *American Finance Association* meetings.

Ronald W. Masulis is a law professor and the Frank K. Houston Professor of Finance at Vanderbilt University, and a visiting professor in finance at the Australian School of Business at the University of New South Wales. His research interests are corporate finance, corporate governance, investment banking, venture capital and international finance.

Randall S. Thomas is the John Beasley Professor of Law and Business at the Vanderbilt Law School and a professor of management at the Owen School of Management at Vanderbilt University. His research interests include shareholder activism, corporate and securities litigation, executive compensation, corporate voting, and corporate governance. He teaches courses in the area of corporate law, including corporations and securities regulation and directs the law school's LL.M. program and its Law and Business academic program. His recent work addresses issues such as hedge fund shareholder activism, executive compensation, corporate voting, corporate litigation and the structure of firms.

Robert B. Thompson is the Peter P. Weidenbruch, Jr. Professor of Business Law at Georgetown Law Center at Georgetown University Law Center. He previously served as the New York Alumni Chancellor's Chair in Law and Professor of Management at Vanderbilt University. His research interests include corporate governance, limited liability, empirical studies, securities regulation, and closely held businesses.

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About the Series Director

Matteo Tonello is director of corporate leadership at The Conference Board in New York. In his role, Tonello advises members of The Conference Board on issues of corporate governance, regulatory compliance, and risk management. He regularly participates as a speaker and moderator in educational programs on governance best practices and conducts analyses and research in collaboration with leading corporations, institutional investors and professional firms. He is the author of several publications, including *Corporate Governance Handbook: Legal Standards and Board Practices,* the annual *U.S. Directors' Compensation and Board Practices* and *Institutional Investment reports, Sustainability in the Boardrooom,* and the forthcoming *Risk Oversight Handbook*. Recently, he served as the co-chair of The Conference Board Expert Committee on Shareholder Activism and on the Technical Advisory Board to The Conference Board Task Force on Executive Compensation. He is a member of the Network for Sustainable Financial Markets. Prior to joining The Conference Board, he practiced corporate law at Davis Polk & Wardwell. Tonello is a graduate of Harvard Law School and the University of Bologna.

About the Executive Editor

Melissa Aguilar is a research associate in the corporate leadership department at The Conference Board in New York focusing on issues of corporate governance, regulatory compliance, and risk management. Prior to joining The Conference Board, she was a contributor for more than five years at *Compliance Week,* where she reported on a variety of corporate governance topics, including proxy voting developments, executive compensation, risk management and shareholder activism. Her work has also appeared in Bloomberg's Bloomberg Brief Financial Regulation newsletter. Previously she held a number of editorial positions at SourceMedia Inc. Aguilar is a graduate of Binghamton University.

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For more information on this report, please contact:
Melissa Aguilar, research associate, corporate leadership at 212 339 0303 or melissa.aguilar@conferenceboard.org

THE CONFERENCE BOARD, INC. www.conferenceboard.org
AMERICAS +1 212 759 0900 / customer.service@conferenceboard.org
ASIA-PACIFIC +65 6325 3121 / service.ap@conferenceboard.org
EUROPE/AFRICA/MIDDLE EAST +32 2 675 54 05 / brussels@conferenceboard.org
SOUTH ASIA +91 22 23051402 / admin.southasia@conferenceboard.org

THE CONFERENCE BOARD OF CANADA +1 613 526 3280 / www.conferenceboard.ca

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