October 21, 2020

Probability, Magnitude and Stock Buybacks: A Cautionary Tale

In a recently settled SEC administrative proceeding,[1] Andeavor LLC, an energy company acquired by Marathon Petroleum in 2018, agreed to pay a $20 million civil penalty for failing to maintain adequate internal accounting controls in connection with its stock buyback plan. The settlement highlights the importance of ensuring that those who execute buyback programs do so with full knowledge of the probability and magnitude of potentially material events, particularly as it concerns M&A activity. In its discussion of acquisition negotiations, the order also suggests that the SEC staff will view "pauses" in M&A discussions with a skeptical eye if and when the potential transaction ultimately comes to fruition.

According to the order, Andeavor and Marathon engaged in M&A discussions in the fall of 2017. After Marathon expressed some concern about the dilutive effect of an acquisition on its cash flow per share, the parties agreed in late October 2017 to suspend discussions. The order states that the Andeavor CEO told its financial advisor that he expected discussions to resume in early 2018. Thereafter, Andeavor received weekly updates from its financial advisor reflecting the two companies' share prices. In late January 2018, the Marathon CEO contacted the Andeavor CEO and they agreed to recommence discussions, recognizing that they did not have to start all over again but could "refresh" their earlier work.

In preparation for a meeting of the CEOs to be held on February 23, the Andeavor team performed an analysis that showed, as a result of the change in Marathon's stock price since the earlier discussions, a transaction between the companies would be accretive to Marathon at premiums well in excess of those that had been earlier discussed. Moreover, their work showed that Marathon's cash flow per share concern should no longer preclude a transaction.

Two days before the CEO meeting, on February 21, the Andeavor CEO directed the CFO to initiate a repurchase of $250 million shares of common stock under an existing $2 billion authorization. The existing authorization required repurchases to comply with Andeavor's securities trading policy, which prohibited purchases while in possession of material, non-public information. The next day the legal department approved a Rule 10b5-1 plan to repurchase the shares after concluding that the Marathon discussions did not constitute material, non-public information at the time.

In the SEC staff's view, this conclusion was based on a deficient understanding of all relevant facts and circumstances. In particular, the legal department, which approved the Rule 10b5-1 plan, used an "abbreviated and informal process to evaluate the materiality of the acquisition discussions" and did not consult the CEO to discuss with him the prospects of a deal occurring. This failure to consult with the individuals most knowledgeable about the significance and probability of important events was a failure of internal controls.

One can imagine how the conversation might have gone when the general counsel, knowing that the CEO requested the share buyback, called to ask him about the status of the discussions between the two companies. Moreover, the order is silent as to whether the legal department might have obtained information about the CEO's state of mind from other sources. The order suggests that simply failing to confer with the CEO was a control violation – and with a civil penalty of $20 million, an expensive one at that.

The case is a reminder that the *Basic v. Levinson*[2] "probability-magnitude" test does not require that a possible event be more likely than not. End-of-corporate-life mergers are material at an earlier stage than almost any other type of transaction. Presumably following suspension of the transaction discussions, as Andeavor monitored the relative share

[1] *In the Matter of Andeavor LLC*, https://www.sec.gov/litigation/admin/2020/34-90208.pdf (October 15, 2020).
[2] *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)

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prices of the two companies with weekly updates from its financial advisor, when the obstacle expressed at an earlier stage of discussions (in this case, impact on acquirer cash flow per share) appeared solved and the Marathon CEO called to resume the discussions, the probability of a transaction increased significantly, at least in the view of the SEC staff with the benefit of hindsight. In addition, while the order does not specifically allocate weight to this point, it appears that the Andeavor CEO believed that discussions were only "suspended"—meaning that they were likely to resume—rather than "terminated," which would have meant they had ended and were unlikely to recommence. Whether discussions are suspended or terminated has the potential to significantly affect the probability component of *Basic v Levinson*, but it is a determination that with hindsight can be subject to significant second-guessing.

It is important to note that no one in this order was charged with trading on material, non-public information—the charge involved the failure to implement adequate controls. The SEC staff presumably concluded that the evidence was not sufficient to prove a scienter-based trading violation. Still, the imposition of a $20 million penalty is no small matter.

Finally, because this case involved an alleged failure of controls, the same result would presumably have applied if at any time following suspension of discussions Andeavor had intiated a buyback plan without consulting the CEO about the possibility of the transaction. For lawyers counseling targets in situations such as this, however, it is interesting to consider whether the probability of the transaction was affected significantly by the January 30 call from the Marathon CEO seeking to recommence discussions. The order notes that Andeavor's financial advisor continued to provide weekly updates about the exchange ratios between the two companies' share prices. Does that fact alone—if the data show the elimination of earlier obstacles to a transaction—sufficiently alter the probability of occurrence? Or was it the call that should have triggered a blackout? Or should the blackout have been put in place only after the Andeavor deal team did the work to demonstrate that a merger could be accretive to Marathon. These questions demonstrate the difficulty of making probability-magnitude assessments, particularly when it will only be tested when the probability turned out to be 100%. Hindsight is always 20-20.

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