



1 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Top 10 Due Diligence Issues in M&A deals

2010 Emerging Issues 5124

SPEED READING: TOP 10 CONSIDERATIONS WHEN DOING M&A DUE DILIGENCE

By Mr. Frank Aquila Esq. and Ms. Melissa Sawyer Esq.

June 17, 2010

SUMMARY: Planning a significant due diligence process can be daunting, even for experienced deal makers. Some foresight and a little preparation can make the process go smoothly. This article outlines ten practical tips for organizing a due diligence exercise to maximize the benefits of the process, while staying on schedule and reducing costs.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ARTICLE: Planning a significant due diligence process can be daunting, even for experienced deal makers. Some foresight and a little preparation can make the process go smoothly. Spending a few hours at the outset thinking through the process carefully can also save a client a tremendous amount of time and money as the deal progresses. By anticipating and preventing roadblocks, focusing in on key issues, determining what deliverables will be most useful and avoiding duplication of efforts, an advisor can develop an effective approach to any M&A due diligence process. Ensuring that diligence findings are communicated efficiently and properly assimilated into the deal negotiations makes all the effort worthwhile. This article outlines ten practical tips for organizing a due diligence exercise to maximize the benefits of the process, while staying on schedule and reducing costs.

This article is part of the "Speed Reading" series in which the authors highlight practical tips and recurring issues in M&A transactions. Other "Speed Reading" articles are: Aquila and Sawyer on Rights Plans, *2010 Emerging Issues 5027* and Aquila and Sawyer on Issues in a Public Company Merger Agreement, *2010 Emerging Issues 4883*.

* * * * *

1. Scoping Out the Assignment

Before starting due diligence, advisors and their clients should pause to discuss the scope of the project. The discussion should cover the following topics, among others:

- *Scope.* What is the scope of due diligence? Is the purpose of the diligence exercise merely to identify issues that could impact the transaction valuation, structure and/or deal timing, or are the diligence findings also expected to form a basis for future integration work?
- *Work Product.* What kind of work product does the client want to receive? Detailed document-by-document summaries or an executive summary that only highlights material issues? The answer will be closely related to the

scope of the project and the expected audience for the report. Delivering a two-hundred page report to a board of directors usually is not appropriate, but the head of an integration team may be thrilled to receive that level of detail.

- *Materiality.* Is there a materiality threshold below which the findings are unlikely to justify the expense of performing diligence? This question is becoming increasingly important because virtual data rooms have made it possible for a seller to give a buyer access to its entire electronic contract database without making any effort to distinguish between a multi-year, multi-million dollar key supplier agreement, on the one hand, and a landscaping contract for the corporate headquarters, on the other hand.
- *Transaction Structure.* How will the transaction be structured? If the target is a public company that files periodic reports and audited financial statements with the SEC, a buyer might elect to (or, in a hostile deal, might have to) rely on a more cursory due diligence review (understanding, of course, that relying primarily on the seller's public disclosures will leave the buyer exposed to undisclosed risks). In contrast, if the transaction is a small asset sale with detailed disclosure schedules, the due diligence may need to be much more granular.
- *Risk Allocation.* What liabilities is the buyer expected to assume? If the business deal is that the buyer will be fully indemnified against all environmental liabilities, for example, it may be more important for the buyer's diligence team to spend its time and money analyzing the credit risk associated with accepting an indemnity from the seller rather than performing a detailed review of the underlying environmental risks.
- *Known Risks.* Should the team focus on any particular types of risks given the identity of the seller or the nature of the industry?

2. Pulling Together the Team and Coordinating Results

When it comes to performing due diligence, advisors are not "one size fits all". Depending on the type of transaction and the industry, a buyer may need to hire multiple specialized diligence providers, such as a tax and financial accounting firm, an actuarial firm (more common in certain insurance deals), a loan portfolio consultant (more common in loan portfolio or banking deals), outside counsel including, in some cases, local counsel, an employee benefits/human resources consultant, an environmental consultant and/or a real property title search firm.

Expanding the team can create coordination challenges, but specialists can often be more cost-effective and deliver better results than generalists in particular subject-matter areas. For example, although internal counsel or outside counsel may be able to review a target's Foreign Corrupt Practices Act compliance policies and procedures, a forensic accountant or similar specialist is better placed to review the target's financial books and records to verify whether the target is compliant with those policies.

When negotiating engagement letters with specialists to perform due diligence, keep the following in mind:

- Make sure the engagement letter accurately describes the scope of the project;
- The legal "boilerplate" is usually very favorable to the specialist, but in many cases can be negotiated to reflect a more reasonable middle-ground; keep in mind, however, that a protracted negotiation with a service provider over the terms of its engagement may delay the diligence schedule;
- Fees are usually negotiable, within a range of reasonableness;
- Consider capping reimbursement for expenses at a reasonable level, above which the specialists will need to revert to the client to get consent for additional extraordinary expenditures;
- Consider whether the engagement letter should include a confidentiality provision and/or a restriction on the specialist's ability to accept an assignment that creates a conflict of interest,
- If time is of the essence, consider including deadlines for delivery of the specialist's reports;
- If specific individuals' expertise is key, consider specifying that those individuals must comprise part of the specialist's team for the project; and
- Make sure the restrictions on the use of the specialist's report do not unduly constrain the client from sharing copies of the report with all key members of the diligence team, including outside financial advisors and outside counsel, and making any requisite regulatory filings.

To manage the challenges of coordinating a large diligence team, consider establishing the following procedures at

the outset, among others:

- Identify a "team leader" who will coordinate scheduling access to data rooms, management presentations, site visits, calls and meetings for the full diligence team; the team leader will also be the "go to" person to whom the team will identify urgent substantive and process-related issues;
- Create a working group list with contact information for everybody on the team;
- Create a "deliverables" calendar to highlight key deadlines for the presentation of due diligence reports; if reports will be presented directly to a board of directors, keep in mind that the directors should receive any written materials a couple of days in advance of the meeting if possible;
- Hold a "kick-off" meeting to identify clearly how to divvy up responsibilities, to discuss the scope of the assignment and to discuss any procedural requirements (such as potential antitrust restrictions on access, which are discussed below);
- Hold periodic team calls to identify challenges in accessing information and allocate resources (both your team's and the counterparty's) most efficiently and to ensure that issues that impact more than one subject matter area are brought to the attention of others on the team; and
- Invite the primary draftsman for the transaction agreements to attend diligence calls/meetings (or get a download afterwards) so that he or she can take into account the issues reported during these sessions when drafting risk allocation provisions.

3. Vendor Due Diligence and Lender Due Diligence

Many due diligence providers contractually restrict who can receive copies of their reports. Make sure you discuss with them in advance whether they are being engaged to prepare a vendor due diligence report (that is, to represent seller and prepare a report that buyers will be allowed to review) or a report that will be shared with lenders to minimize the lenders' due diligence costs. U.S. law firms generally will not permit non-clients to rely on their due diligence reports, and will require lenders and others to sign "non-reliance" letters as a condition of receiving a copy of their report. Typically the non-reliance letters include an extensive release from liability. Sharing reports can provide a big cost-savings to a target that is seeking to provide stapled financing, or to a buyer who is urgently seeking to pull together a bid with committed financing.

Setting aside the "reliance" issue, dealing with lender due diligence in a transaction can present additional coordination challenges for a diligence team. Lenders may be focused on different diligence issues than a buyer, such as the lender's ability to take security interests in the target's assets. Too many detailed diligence requests from a lender have the potential to overwhelm and distract an unsophisticated target's deal team from negotiating key deal terms like price and deal certainty. On the other hand, any failure to work cooperatively with a lender to satisfy its diligence requests can delay the ability to get commitment letters or cause the lenders to require a dreaded "diligence out". It is best to discuss up front with potential lenders what their pre-signing diligence requirements will be, and how best to integrate the lender's diligence into the overall process and timetable.

4. Complying with Antitrust Laws and Other Regulatory Considerations

After a diligence team "scopes out" the assignment, the team should consult with legal counsel to confirm whether there are any antitrust or other regulatory constraints on their work. For example, certain regulated industries impose restrictions on sharing certain types of information, such as exam reports in the case of some banks. In addition, when counterparties are key competitors in the same industry, it may be advisable to restrict access to certain types of competitively sensitive information. The parties can develop firewall procedures to ensure that individuals with responsibility for setting pricing at the buyer, for example, cannot access information about the target's pricing or cost of goods sold. These procedures might include:

- Ensuring that the seller's antitrust counsel reviews all data room materials and management presentations for competitively sensitive information prior to making them available to the buyer;
- Redacting pricing and other competitively sensitive information from documents before providing copies in a data room;

- Setting up a separate "clean room", or establishing "restricted access" passwords for virtual data rooms, to segregate competitively sensitive information from non-competitively sensitive information;
- Using a virtual data room program that tracks who accesses which information, and restricts people from printing or downloading competitively sensitive information;
- Ensuring that members of the diligence team sign individual letter agreements agreeing to observe the antitrust protocols;
- Limiting the number of people at the client who are able to receive and review diligence reports that may contain summaries of competitively sensitive issues; and
- Ensuring that a legal advisor attends all substantive meetings between the parties to make sure that discussions do not cross the line of what is permissible under applicable law.

It is essential that appropriate counsel, aware of all the facts and circumstances, is consulted before such procedures are put in place. Such counsel should be consulted regularly as the process moves forward. While firewall procedures may be necessary in some cases to protect both the buyer and the seller from liability, buyers should beware of unjustified seller claims that information is "sensitive" or "restricted" where the seller is merely trying to withhold key diligence information so that the buyer cannot take it into account in its valuation. Also, in an auction process, bidders should work with the seller to ensure they are not disadvantaged by the firewall procedures as compared to other bidders.

5. Preserving Confidentiality and Establishing Other Due Diligence Procedures

Before commencing any due diligence process, the parties should sign a confidentiality agreement and agree on other due diligence procedures with each other. The latter includes the following matters, among others:

- Will the buyer be granted an exclusivity period during the due diligence phase of the transaction?
- Will the buyer be required to agree to a standstill as a condition of doing due diligence on the target?
- If the buyer is planning to bring in equity co-investors, can the equity co-investors conduct their own due diligence in their capacity as "representatives" of the buyer or will they need to sign separate confidentiality agreements?
- Will the buyer be permitted to make copies of the target's data room information? If using an electronic data room, will the buyer be able to print and/or download files from the data room?
- Does the target have any particular issues for which diligence is expected to be costly and for which buyer would expect to be reimbursed if the target elects not to proceed with a transaction with the buyer?
- Would the target prefer that all diligence requests flow through an external representative, such as a financial advisor, so as not to overtax the management team?
- Does the target have any internal firewalls or other restrictions on which target employees can be "in the loop" about the transaction? Should the parties develop a "cover story" to explain buyer's diligence to the target's employees, such as pretending that the buyer is a potential lender that the target is considering using for a refinancing transaction?

6. Addressing Privilege Issues

A buyer usually will want to fully investigate a target's litigation and regulatory issues. However, the target may worry that revealing too much about its litigation strategy, estimates of liability and internal investigations could destroy attorney-client privilege or similar protections the target may otherwise wish to preserve. The parties should consult with litigation counsel to assess whether it is possible to avoid this outcome. One option frequently explored by parties in M&A deals is entering into a joint defense agreement or a common interest agreement. The concept of such an agreement is that the buyer, who will succeed to all or some of the assets and liabilities of the target, should not be viewed as a third party because the buyer and the target share a common interest in the resolution of the claims. Even if litigation counsel advises that such an agreement may be effective to preserve privilege, counsel may recommend that the parties take additional steps to bolster their arguments in favor of privilege, such as restricting access to the privileged information only to outside counsel. Tread carefully! Experienced litigation counsel must be consulted whenever dealing with potential privilege issues.

7. Getting Started Before Getting Access

A buyer can complete a lot of due diligence before even getting access to the target's confidential information. This "desktop" due diligence often provides a good basis for previewing key issues that can shape an initial indication of interest in an auction process and/or considering whether to devote more resources to a potential acquisition. Examples of this type of due diligence include the following:

- SEC filings and comparable filings in other jurisdictions;
- Websites;
- One-Source Reports and similar subscription-based information sources;
- Background checks on management;
- Litigation docket searches;
- UCC lien searches;
- Obtaining good standing certificates from secretaries of state or similar offices;
- Environmental reports available from regulatory agencies; and
- Other publicly available regulatory filings and reports.

8. The Critical Importance of Management Presentations, "Subject Matter Expert" Break-Out Due Diligence Sessions and Site Visits

Before sending a team of hundreds of service providers into a data room to start reviewing thousands of documents, a buyer should insist that the target schedule oral discussions about key issues with its management team. In most deals, these discussions would include presentations by teams from the following departments: finance, operations, legal and information technology. In certain industries, they could also include: regulatory/compliance, facilities and other subject matter-specific areas. Live discussions of key issues can help the buyer to streamline its diligence and focus in on key areas. They can also put the diligence in context of the seller's businesses and inform the buyer about key decisions, such as the appropriate level of materiality for focusing the scope of the due diligence. When pressed with the right questions by knowledgeable diligence teams, sellers' management teams are often very open about key risks and what steps the seller has undertaken to mitigate issues. In an auction context, management presentations can also provide vitally important strategic information. For example, if the management team seems "rough" and unprepared to answer basic questions, the buyer might surmise that none of the other bidders in the process are serious contenders.

As a process matter, it is generally better to designate one or two individuals on the buyer's team to lead Q&A sessions with seller's management team. It is often possible to open a conference line to allow others from the buyer's team to listen in to the discussions as silent participants.

In deals where the seller is divesting manufacturing facilities, the buyer may also want to conduct site visits. Seeing a seller's facilities first-hand and discussing the seller's operations with local site managers can reveal important information about the quality of the seller's operations and technology, its safety and compliance standards and the morale of its work force. The buyer should make sure that it gets to influence the choice of locations and timing so that seller does not limit the visits to its best and most prepared facilities. A buyer's desire for site visits, however, has to be balanced against the need for confidentiality. Having a team of ten "suits" walking through a plant on short notice without a good cover story is often the first tip-off to labor that a deal is in the works, which in turn can affect employee retention.

9. Putting a Value on an Issue

It can be frustrating for clients when their diligence teams spot potential risks but are not able to put a value on them. It can be equally frustrating for advisors when clients ask them to quantify speculative, unknown and contingent risks. To bridge this gap, it is sometimes helpful to categorize risks into different buckets, including the following:

- Are they ordinary course industry-specific risks? If the buyer is already operating in the same industry as the seller,

the buyer's own management team will likely be best placed to analyze and quantify these risks.

- Are the risks covered by insurance or indemnities from third parties? Will the insurance or indemnities be available to the buyer post-closing? Can the buyer purchase insurance to cover the risk, and, if so, how much would the insurance cost?
- Has the target placed reserves on its financial statements for the risks? If so, how did it calculate the size of the reserves? How much of the reserves has it used in the past?
- If the target is a public company, has the risk been disclosed publicly such that the target's market price may already include a discount to take account of the risk?
- Can an economist assist with quantifying the potential liability? This might be the case, for example, if the target is the subject of securities class action litigation.
- Does the target have any claims experience with similar risks that could be used as a guide to assess potential liabilities? Do comparable companies in the same industry disclose their historical claims experience in relation to similar risks?
- What steps, if any, has the target taken to mitigate the risk? Is the target following best practices to address the issue?
- Could the risk carry ancillary consequences, such as reputational harms, that would impact the buyer's other businesses if the buyer proceeds with the transaction?
- Fundamentally, is the risk a deal-breaker such that the buyer would not be willing to proceed with the transaction due to the magnitude or nature of the exposure?

10. Recurring Substantive Issues in M&A Legal Due Diligence

Every transaction is unique, every company is unique and, accordingly, every due diligence process is unique. However, there are at least a few recurring issues that should be part of every M&A deal's legal due diligence process. Here are some examples:

- *Change of control and anti-assignment provisions.* If a target's most important assets include its contracts and relationships with third parties, the buyer's diligence team needs to assess whether those contracts and relationships will survive unaffected by the transaction. The answer will depend in part on the language of the contract, the governing law of the contract and the structure of the transaction. The answer also depends on the buyer's and the target's relationship with the counterparty. Breaching a transfer restriction could trigger liquidated damages, termination rights or other mechanics that could impact the valuation of the transaction and the viability of the business post-closing. It is critical to understand how valuable the relationship is, whether the provision is applicable, and what the consequence of triggering the provision would be. Keep in mind that imposing liens in connection with transaction financing may also trigger consent requirements under these provisions.
- *Non-compete, exclusivity and MFN provisions.* If the buyer currently operates in (or plans to expand its operations into) the same industry as the target, the buyer needs to be very careful not to "acquire" non-compete, exclusivity or "most favored nation" provisions that could be broadly construed to apply to the buyer's businesses, not just the target's businesses. For example, if the target has entered into a contract that restricts target "and its affiliates" from selling widgets during the term of the contract, the buyer currently sells widgets and the transaction structure is such that the buyer will be an affiliate of the target post-closing, the buyer needs to evaluate carefully the consequences of violating the widget non-compete.
- *Related party transactions.* The buyer should investigate transactions between the target and related parties (or formerly related parties) carefully for at least two reasons: (i) the terms may not be arms-length (that is, the transactions may be on favorable terms that will not be available to the buyer upon renewal of the agreement, or the terms may be unusually adverse to the buyers) and (ii) the buyer may have disclosure and compliance obligations related to the arrangements post-closing.
- *Debt instruments.* Debt instruments can be the most complex documents to review in a due diligence process. Not only may they contain change of control defaults, but in the case of public debt the transaction structure may require the parties to determine how the issuer can conduct an issuer tender offer to repurchase the debt or a consent solicitation to address potential defaults resulting from the transaction. Restrictive covenants and ratings conditions in an indenture or credit agreement can also be a source of defaults in connection with a transaction. The buyer's diligence team needs to

understand not only the target's debt instruments, but also how those instruments relate to the buyer's existing debt (for example, to analyze the potential for cross-defaults).

- *Capital structure.* A complete understanding of the target's capital structure is fundamental to structuring any stock purchase, merger or similar transaction. The buyer needs to diligence the classes and series voting and non-voting equity securities (including options, warrants and other derivatives), and understand what rights each type of security will have to vote on the transaction and whether the securities can be cancelled in the transaction without the consent of the holder. A related question is whether a stockholders' agreement or similar agreement gives any of the holders special rights that could be triggered by the transaction, like rights of first refusal/first offer, tag-along rights, drag-along rights, preemptive rights or registration rights.

* * * * *

Even the most modest due diligence process entails the expenditure of significant time and resources. Making sure that the client obtains full value from the due diligence effort is essential. The person in charge of reviewing diligence reports from various advisors should be able to take that information and translate it into structuring discussions and risk allocation negotiations. Examples of practical applications of diligence information include the following:

- Reviewing the seller's representations and warranties and evaluating the seller's disclosure schedules;
- Determining the optimal form and timing of consideration, including determining whether any post-closing earn-outs or purchase price adjustments are appropriate, and determining what accounting adjustments may be desirable for these calculations;
- Determining whether either party will require any transition services;
- Determining whether to make a Section 338(h)(10) election or whether other tax considerations will influence the transaction structuring;
- Determining whether to seek regulatory or third party consents pre-signing and between signing and closing, and determining what shareholder approvals are required;
- Assessing which of the target's debt, if any, would need to be paid off at closing, and how the pay-off would be effected;
- Planning for customer, employee and investor outreach in connection with the announcement of the deal; and
- Analyzing employee compensation and benefits issues, structuring employee retention arrangements and analyzing the tax consequences of employee severance and change in control payments.

Remember that due diligence is not an end in and of itself. It is all too easy to get caught up in the process of following checklists, losing the forest for the trees and failing to adapt to changing dynamics as the process evolves. These ten tips for getting started in a diligence process are not one-size-fits-all suggestions and obviously do not address the myriad of substantive issues that can come to light in any given diligence process. However, thinking through these issues at the outset can help to prepare a diligence team to be effective, timely and efficient.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Frank Aquila is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. His practice focuses on mergers, acquisitions, strategic alliances and corporate governance matters for large multinational corporations. Mr. Aquila was an American Lawyer "Dealmaker of the Year" in 2009 and is the 2010 recipient of the Atlas Award as the "Global M&A Lawyer of the Year." Mr. Aquila has also received Burton Awards for Legal Achievement in 2005 and 2010. He received his A.B. degree from Columbia University and his J.D. degree from Brooklyn Law School.

Melissa Sawyer is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. Her practice has focused on a variety of corporate, M&A and private equity matters in the U.S. and abroad. Ms. Sawyer was featured in "The Facebook of Wall Street's Future" (New York Times, October 3, 2007) as one of Wall Street's "next generation of

deal makers." She received her B.A. degree from Washington & Lee University and her J.D. degree from the University of Virginia Law School.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



2 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

The Fiduciary Duties of Acquiring Directors

2010 Emerging Issues 5090

Stephen I. Glover on The Fiduciary Duties of Acquiring Directors

By Stephen I. Glover Esq. and Renee M. Strandness Esq.

June 3, 2010

SUMMARY: Relatively few cases address the fiduciary duties of an acquiring board. These cases indicate that, absent a conflict of interest, courts will generally apply the deferential standard of the business judgment rule to a board's acquisition decision. Nonetheless, recent highly publicized failed acquisitions--and the subsequent shareholder lawsuits generated by these failed acquisitions--indicate that an acquisition decision is not without risk.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Although numerous cases address the fiduciary duties of the directors of a company being acquired, there is a relative paucity of authority regarding the duties of an acquiring board of directors. Generally, courts apply the deferential standard of the business judgment rule to a board's acquisition decision. This deference contrasts sharply with the heightened level of scrutiny courts apply to decisions involving defensive measures taken by a takeover target's board of directors. In light of the deference accorded to an acquiring board's decision, there is less incentive for shareholders to launch a derivative suit against the acquiring board. Nonetheless, acquiring directors should be mindful of their fiduciary duties when reviewing a proposed acquisition, as the decision acquiring directors must make is not without significant risk.

Numerous corporate unions fail to generate value for shareholders or, worse yet, destroy shareholder value. Recent high-profile examples of failed corporate marriages include AOL and Time Warner, Daimler-Benz and Chrysler, and, most recently, EBay and Skype. Following the 2001 AOL Time Warner merger, for example, the combined company's stock price plummeted, and more than \$100 billion in shareholder value was ultimately lost. This ill-fated marriage eventually ended in divorce: in 2009, AOL spun off from Time Warner. Likewise, in 2007, private-equity group Cerberus Capital Management purchased a majority interest in Chrysler from its parent company, thereby unwinding the unsuccessful 1998 merger of Daimler-Benz and Chrysler. Recently, EBay similarly shed its own acquisition albatross upon completion of the sale of a majority interest in internet communications company Skype, which it acquired in 2005. Ill-advised acquisitions may have even more dramatic consequences: a poorly executed "acquisition binge" has been cited as a contributing factor to the demise of WorldCom, the telecommunications firm riddled by scandal in the early 2000s.

Significantly, failed mergers often generate lawsuits. For example, in the wake of Time Warner's unsuccessful merger with AOL, the combined company faced over 100 shareholder lawsuits, which cost the company an aggregate of

roughly \$3.75 billion. A number of these lawsuits alleged, among other things, that AOL Time Warner directors and officers breached their fiduciary duties by issuing materially false and misleading statements concerning the financial condition of AOL prior to the merger, the expected synergies of the merger and the combined company's business prospects and earnings projections. In addition to such derivative lawsuits, AOL Time Warner faced myriad class action lawsuits alleging state law claims of fraud and misrepresentation, as well as violations of the federal securities laws and ERISA. Numerous shareholder lawsuits similarly plagued DaimlerChrysler as the combined automaker's stock price steadily declined following the merger. These lawsuits generally alleged that the company and certain members of its supervisory board and board of management violated federal securities laws by describing the transaction as a "merger of equals" in its proxy statement/prospectus and in other communications.

In light of the risks attendant to acquisition transactions, it is imperative that the directors of an acquiring company have a clear understanding of their fiduciary duties. Below, we review the current state of Delaware law regarding the fiduciary duties of acquiring directors and provide practical guidance for directors faced with an acquisition decision.

In re Dow Chemical: An Affirmation of the Business Judgment Rule

As noted above, relatively few cases specifically discuss the fiduciary duties applicable to an acquiring company's board of directors. Recently, however, the Delaware Court of Chancery had the opportunity to address this issue when shareholders of the Dow Chemical Company filed a derivative action seeking to recover losses arising from Dow's 2009 acquisition of Rohm & Haas Company. The resulting opinion, *In re the Dow Chemical Company Derivative Litigation*, 2010 Del. Ch. LEXIS 2 (Jan. 11, 2010), is a clear affirmation of the applicability of the business judgment rule to situations in which disinterested directors make an informed, good faith decision to acquire another company—even if the acquisition proves to have been unwise in hindsight.

Factual Background

The *Dow Chemical* decision arose from two transactions initially approved by the Dow board in 2007 and 2008. In late 2007, Dow and Kuwait's Petrochemical Industries Company entered into a memorandum of understanding under which Dow would receive \$9 billion in cash upon the transfer of a 50% interest in five Dow commodities chemical businesses in a joint venture with Kuwait. Dow expected that the Kuwaiti joint venture would close in late 2008. In July 2008, the Dow board unanimously approved a merger agreement with Rohm & Haas, pursuant to which Dow agreed to acquire all of Rohm & Haas' stock for approximately \$15.6 billion in cash and to assume approximately \$3 billion of Rohm & Haas' debt. The merger agreement followed an intense bidding contest among several large chemical companies. As a result of Dow's weakened bargaining position, the merger agreement did not condition the transaction's closing on Dow's ability to obtain financing, and it did not provide any of the traditional "outs" typically present in a merger agreement. At the time Dow entered into the merger agreement, Dow had a variety of potential sources of financing for the Rohm & Haas deal, and the acquisition did not depend on the closing of the Kuwaiti joint venture.

Soon after Dow signed the Rohm & Haas merger agreement, however, economic conditions began to deteriorate and the credit markets tightened, thereby increasing the importance of the prospective proceeds from the Kuwaiti joint venture to Dow's ability to finance the Rohm & Haas transaction. Unfortunately, in December 2008 the Kuwait Supreme Petroleum Council rescinded its approval of the Kuwaiti joint venture. In January 2009, Dow refused to close the Rohm & Haas transaction following the grant of final antitrust clearance, as the merger agreement required, and Rohm & Haas filed suit against Dow, seeking specific performance of the merger agreement. The parties eventually settled the lawsuit, and the merger closed in April 2009, on substantially altered financial terms.

The Court's Decision

In *Dow Chemical*, the plaintiff shareholders claimed, among other things, that the Dow director defendants breached their fiduciary duties in approving Rohm & Haas acquisition. Ruling on the defendants' motion to dismiss, the Delaware Court of Chancery explained that, in order to show demand futility, the plaintiffs had to raise a reasonable

doubt that either (i) a majority of the directors who approved the Rohm & Haas acquisition were disinterested and independent, or (ii) the Rohm & Haas acquisition was the product of the board's good faith, informed business judgment. Noting that nine of the twelve Dow directors were outside directors, and that none of the directors were alleged to have an interest in the acquisition, the court concluded that plaintiffs had failed to raise a reasonable doubt that the majority of the directors who approved the transaction were disinterested and independent.

Significantly, the court further determined that the business judgment rule protected the Dow directors' decision to enter into the Rohm & Haas transaction. The court noted that plaintiffs made no allegations that the board failed to take the time and effort necessary to evaluate the transaction, that the board was unaware of any material terms of the transaction or that the board failed to obtain expert advice on the transaction. In fact, Dow had performed due diligence with respect to the deal. "Simply put," the court explained, "plaintiffs take issue with the substantive decisions of the [Rohm & Haas] [t]ransaction, instead of the *process* the board followed." *Id.* at *37 (emphasis added). The Dow board was operating in a competitive bidding environment, the court noted, and made a business decision to approve the transaction without a financing condition based on the fear that Rohm & Haas might otherwise walk away from the deal. The court refused to second-guess this business decision, as that would be "precisely the kind of inquiry that the business judgment rule prohibits." *Id.*

The court also discounted the plaintiffs' argument that the Rohm & Haas acquisition did not merit the protection of the business judgment rule because it was a "bet the company" transformational transaction, rather than a basic exercise of business judgment. "Delaware law," the court explained, "simply does not support this distinction." *Id.* According to the court, regardless of whether a good faith, informed decision made by disinterested directors relates to an isolated transaction or is part of an overarching transformative plan, the decision will be entitled to the deference of the business judgment rule.

Judicial Deference to Good Faith, Informed and Disinterested Decisions

As *Dow Chemical* makes clear, a good faith, informed business decision of disinterested directors to acquire another company generally will enjoy the protection of the business judgment rule. A long-established tenet of Delaware law, the business judgment rule rests on the assumption that courts must afford the managerial decisions of a board of directors a degree of deference. Directors regularly must make complex business decisions, and the rule recognizes that courts are ill-equipped to second-guess the substance of such decisions.

Further, the rule acknowledges that directors should be afforded protection for risk-taking, an essential component of corporate growth and innovation. The Delaware Court of Chancery recently reaffirmed this principle in *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009), in which shareholders alleged that the directors and officers of Citigroup breached their fiduciary duties by failing to properly monitor and manage the risks the company faced as a result of its exposure to the subprime lending market. In rejecting this claim, the court emphasized that the mere fact that a company takes a business risk—even a risk that ultimately causes substantial loss—cannot, without more, serve as a basis for liability. *Id.* at 130. The business judgment rule, the court explained, protects the judgment of directors and officers in evaluating the tradeoff between risk and return; imposing liability for taking a risk that proves to be a poor decision in hindsight would impair the ability of companies to earn returns for investors through risk-taking. *Id.* at 126.

Procedurally, the business judgment rule creates a presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Gantler v. Stephens*, 965 A.2d 695, 705-06 (Del. 2009) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). In order to rebut this presumption, plaintiffs must show that directors breached either their duty of care or their duty of loyalty. If plaintiffs succeed in rebutting the presumption, the burden shifts to the defendant directors to show that the transaction was "entirely fair" to the corporation and its shareholders. *Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27, 52 (Del. 2006).

Duty of Care

The duty of care requires that directors inform themselves of all material information reasonably available to them before making a decision. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). Thus, the duty of care inquiry focuses on the *process* employed by directors in making a decision. Directors breach their duty of care if they are grossly negligent with respect to this process. Even an acquisition decision that proves to be economically unwise in hindsight, as in *Dow Chemical*, will not run afoul of the duty of care so long as directors acted in "a deliberate and knowledgeable way in identifying and exploring alternatives." *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989). In light of the emphasis that Delaware courts place on the process employed in board decision-making, directors considering an acquisition can take a number of steps, outlined below, to ensure that their decisions satisfy the duty of care.

Due Diligence. Overseeing a due diligence review of the target company is an essential component of the director's duty of care. An acquiring company should use due diligence to assess the condition and value of the assets and liabilities of the target company, and to identify problems, such as operational problems, financial issues, environmental liabilities or intellectual property issues, that might hinder completion of the transaction, lead to future shareholder lawsuits or prevent the business from succeeding post-merger. Although it is not necessary for directors to perform due diligence research themselves, they should confirm that management and outside advisors have performed an adequate review. Directors should use due care in reviewing the facts and issues that emerge as a result of the due diligence review and should play an active role in the due diligence process by asking questions, requesting reports and making suggestions.

Acquisition Terms. The board should also consider carefully the significant terms of the acquisition, including, most importantly, the price the acquiring company will pay for the target. The price paid in similar acquisitions can provide a useful benchmark in assessing the transaction under consideration. Directors should also supervise the negotiation process to ensure that they are satisfied with the terms management has negotiated.

Strategic Purpose & Integration. In addition to considering the results of the due diligence review and the deal terms, as described above, directors should also focus on the larger picture. Directors should consider the strategic purpose of the acquisition and the synergies that the acquiring company plans to capture. In this vein, directors should ask whether there are alternatives to the acquisition in question that might also satisfy the company's strategic goals. In addition, directors should ensure that an experienced team is ready to assist with the integration process immediately upon closing. Many combined businesses, such as AOL Time Warner and DaimlerChrysler, have suffered as a result of management's failure to capture purported synergies or properly integrate the two entities post-merger.

Speed of Deliberation. Since the seminal case of *Smith v. Van Gorkom*, Delaware courts reviewing duty of care claims have emphasized the importance of the speed at which the deliberative process takes place. An acquiring board should ensure that it has adequate time to assess the acquisition decision, as "boards that have failed to exercise due care are frequently boards that have been rushed." *McMullin v. Beran*, 765 A.2d 910, 922 (Del. 2000). A number of cases have suggested that one or two meetings of short duration may be insufficient to satisfy the duty of care. Delaware courts do recognize that, in certain situations, the amount of time available for deliberation may be constrained by deadlines, crises or other extraordinary circumstances. *See, e.g., Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 54-56 (Del. 1989). If faced with time pressure, the board should work efficiently and intensively, if necessary, to ensure that the deliberative process is adequate. In addition, when faced with this problem, the board may wish to consider whether the ostensible benefits of the acquisition outweigh the risks associated with hasty action.

Reliance on Advisors. Pursuant to Section 141(e) of the Delaware General Corporation Law, directors may rely in good faith on experts, such as financial and legal advisors, who have been selected with reasonable care. Financial advisors can provide fairness opinions, as addressed in more detail below, or assist in evaluating potential alternative transactions. Legal advisors may examine, among other things, securities law, antitrust and fraudulent conveyance issues. Directors should not rely on the conclusory statements of advisors and experts, but should question and discuss

issues with them. *See, e.g., Chesapeake Corp. v. Shore*, 771 A.2d 293, 334 (Del. Ch. 2000) (finding that the duty of care had been breached when "[t]he board's impoverished deliberations were only once supplemented by expertise" consisting of a five-minute presentation, during which the board asked no questions).

Fairness Opinions. Although not required under Delaware law, an acquiring board may wish to consider obtaining a fairness opinion to address the risk of overpaying for the target company. In a fairness opinion, an investment bank or other third-party financial advisor provides an evaluation as to whether a transaction meets a threshold level of fairness from a financial perspective. A fairness opinion may be advisable when:

- A conflict of interest is present;
- The target company is purchased with acquiring company stock subject to price volatility;
- An acquisition is particularly large, complex or material;
- The target company is particularly difficult to value;
- The acquisition marks a significant departure from the acquiring company's strategic plan; or
- The acquiring company must commit material resources to the acquisition.

A board may also wish to consider the adoption of a policy governing when a fairness opinion should be obtained. Such policies are particularly useful at companies that regularly use acquisitions as a growth tool.

Directors, however, should be cautioned that a fairness opinion is not a panacea: a certain amount of subjectivity is inherent in the valuation analysis underlying a fairness opinion, and the fee arrangement for a fairness opinion may incentivize the financial advisor to provide a favorable opinion. As such, directors should not rely solely upon a fairness opinion in evaluating a proposed acquisition; rather, the fairness opinion should serve as only one of many factors considered in the board's evaluation process. Further, directors should consider the more in-depth "board book," which details the underlying analyses prepared and used by the financial advisor in rendering its opinion.

Duty of Loyalty

The duty of loyalty requires a director to act in the good faith belief that his or her actions are in the best interests of the corporation. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006); *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).ⁿ² As Delaware courts have repeatedly noted, classic examples of director self-interest in a business transaction include situations in which a director appears on both sides of a transaction or a director receives a personal benefit from a transaction not received by the shareholders generally. *See, e.g., Cede & Co. v. Technicolor*, 634 A.2d 345, 632 (Del. 1993).

Entire Fairness. When conflicts of interest are present,ⁿ³ Delaware courts may examine the "entire fairness" of the transaction to all shareholders. As explained above, if plaintiffs succeed in rebutting the presumption of the business judgment rule (by proving a breach of the duty of care or, more commonly, the duty of loyalty), the burden of proof shifts to the defendant directors to show that the transaction was "entirely fair" to the corporation and its shareholders. As articulated by Delaware courts, the entire fairness standard has two components: "fair dealing" and "fair price." *See, e.g., In re Digex, Inc. Shareholders Litigation*, 789 A.2d 1176, 1207 (Del. 2000). Fair dealing concerns, among other things, how the transaction was initiated, structured and negotiated. The fair dealing inquiry also examines how the transaction was disclosed to directors and how the approvals of the directors and stockholders were obtained. In evaluating fair price, a court will consider the economic background and financial terms of the transaction, including the company's market value, assets, earnings, future prospects and any other factors that affect the intrinsic value of the company's stock.

Special Committees. When a conflict of interest is present in a potential acquisition transaction, best practice dictates that the board generally should establish a special committee of disinterested board members to evaluate and approve the proposed acquisition. Ratification of the transaction by a majority of disinterested directors serving on a special committee may shift the burden of proving entire fairness from the director defendants to the plaintiffs.

The special committee should be established with care: only a "truly independent, fully informed" committee with "the freedom to negotiate at arm's length" will serve to shift the burden of proof. *In re Tele-Communications, Inc. Shareholders Litigation*, 2005 Del. Ch. LEXIS 206, at *33 (Del. Ch. Dec. 21, 2005). Delaware case law suggests that the committee should have a clear mandate, engage independent advisors and fully inform itself regarding the acquisition. *See id.* at *36-50. Further, the committee members should not receive "contingent, ambiguous, or otherwise uncertain" compensation for their services. *Id.* at *19. In addition, a truly independent special committee should not allow interested directors to control the committee's agenda or decisions.

A special committee may be useful even in the absence of a conflict of interest. Many boards have decided that convening numerous meetings of the full board to consider an acquisition decision is not practical. To solve this problem, they establish a special committee of directors that can more easily convene with sufficient frequency to conduct a thorough review of the proposed acquisition.

Other Legal Standards Applicable to an Acquiring Board

Duty to Disclose

When directors are seeking shareholder approval of an acquisition, the duty of disclosure, or candor, requires directors to disclose all material information about the acquisition to shareholders. The duty of disclosure applies to proxy statements and all other disclosures made in the process of obtaining shareholder approval of an acquisition decision. *See Gantler v. Stephens*, 965 A.2d 695, 710 (Del. 2009). In order for a plaintiff to prevail on a disclosure claim, the alleged misrepresentation or omission must be material, and the plaintiff must show "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* The business judgment rule does not protect directors against a duty of disclosure claim. *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669, 675 (Del. Ch. 1986).

The recent litigation arising out of Bank of America's 2008 acquisition of Merrill Lynch highlights the importance of the duty of disclosure in the context of an acquisition decision. Following approval of the \$50 billion acquisition by Bank of America shareholders and the closing of the acquisition, facts regarding Merrill Lynch's heavy 2008 losses began to emerge, and Bank of America's stock price declined. In addition to the widely publicized Securities and Exchange Commission enforcement actions brought against Bank of America in connection with the acquisition, shareholders have filed numerous derivative lawsuits against current and former directors and officers of Bank of America alleging, among other things, that defendants breached their fiduciary duties in failing to disclose the deterioration of Merrill Lynch's financial condition prior to shareholder approval of the acquisition.

Directors should also be cognizant of their fiduciary duties in relation to disclosure outside of the context of a request for shareholder approval. In *Malone v. Brincat*, 722 A.2d 5, 14 (Del. 1998), the Delaware Supreme Court explained that if directors "knowingly disseminate false information that results in corporate injury or damage to an individual stockholder," they have violated a fiduciary duty. The court clarified, however, that the duty implicated in such a situation is not the duty to disclose, but the duty of loyalty. *Id.* at 10.

Doctrine of Corporate Waste

The doctrine of corporate waste can also serve as a basis for a shareholder suit against the directors of an acquiring corporation. Corporate waste, which has been described as a corollary to the business judgment rule, requires a plaintiff to prove that a transaction is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Brehm v. Eisner (In re Walt Disney Co. Derivative Litigation)*, 906 A.2d 27, 74 (Del. 2006).

As this rigorous standard suggests, a corporate waste claim is very difficult to establish. In *Ash v. McCall*, 2000 Del. Ch. LEXIS 144 (Del. Ch. Sept. 15, 2000), plaintiffs asserted a corporate waste claim against an acquiring corporation's board of directors. In *Ash*, three months after the acquisition in question, the combined company

announced that it had discovered pre-merger accounting irregularities, and the combined company's stock price fell by nearly fifty percent. Rejecting the plaintiffs' corporate waste claim, the Delaware Court of Chancery noted that the transaction did not appear wasteful at the time the acquiring company entered into it. Plaintiffs, the court explained, fundamentally misunderstood the claim of waste, which cannot be established by "examining a corporate transaction with perfect 20/20 hindsight and declaring that it turned out . . . so horribly that it must be a waste of corporate assets." *Id.* at *26. Thus, *Ash*, like the *Dow Chemical* and *Citigroup* decisions described above, affirms that the court will not second-guess the substance of an acquiring board's decision, regardless of how foolish that decision might appear in hindsight.

Practical Guidance for Acquiring Directors

In view of the case law described above, we offer the following guidance to directors considering an acquisition decision:

- *Strategic Purpose and Alternatives.* Directors should consider the strategic purpose of the acquisition and the synergies it is intended to capture. They should review the costs and benefits of the acquisition, as well as any alternatives to the acquisition. Directors should also consider and question, if necessary, the assumptions management makes about future growth and other factors weighing in favor of the acquisition.
- *Due Diligence.* Directors should ensure that management has performed sufficient due diligence on the target company. While directors need not actually perform the underlying research themselves, they should take an active role in the due diligence process by reviewing facts and issues that arise, requesting reports, asking questions and making suggestions. Directors should strive to understand the potential problems and risks attendant to the acquisition in order to make an informed business judgment regarding the transaction.
- *Pricing and Other Terms.* Directors should supervise management's negotiations and carefully consider the transaction terms, with a particular emphasis on price. Directors should ask how the price compares to that paid in similar transactions and how the company intends to service any acquisition debt.
- *Financing.* Directors should consider the financing of the acquisition and its impact on the company. In particular, they should ask how the acquisition is expected to affect the market for the company's stock.
- *Advisors and Fairness Opinions.* Directors should consider retaining independent and experienced financial advisors to assess the costs and benefits of the acquisition and the pricing terms. To address the risk of overpayment, fairness opinions are advisable in a number of acquisition scenarios, including when a conflict of interest is present, when the target is purchased with the acquiror's stock, when a transaction is large, complex or material, when the target is difficult to value, or when the acquisition marks a significant strategic departure for the acquiror. A board may wish to consider adopting a formal policy regarding when a fairness opinion should be obtained.
- *Implementation.* Post-merger integration is often critical to the success of a merger. Best practice dictates that before making an acquisition decision, directors should ensure that management has a well thought-out implementation plan for the integration of the companies post-merger.
- *Speed of the Deliberative Process.* Directors should strive not to make the acquisition decision in haste. If a quick decision is necessary, directors should redouble their efforts to thoroughly review the transaction. If there is not sufficient time to consider the acquisition adequately, directors should not approve it.
- *Special Committees.* If a conflict of interest is present, the board should form an independent committee of disinterested directors to review and approve the transaction. The committee should be free from the influence or control of interested directors, understand its mandate, engage independent advisors and fully inform itself regarding the acquisition. A special committee may also be useful if convening numerous board meetings to consider a transaction would be impractical or unwieldy.
- *Disclosure.* When shareholder approval is necessary, directors should ensure that the company provides sufficient disclosure to allow shareholders to make an informed decision. Directors should also ensure that the company discloses accurate information regarding an acquisition even if shareholder approval is unnecessary.

Conclusion

In practice, the protection of the business judgment rule will likely apply to an acquisition decision, absent a

conflict of interest. However, acquisitions frequently fail, and unsuccessful transactions may result in the loss of shareholder value and costly, time-consuming litigation. In light of these risks, directors of an acquiring company should exercise due care in evaluating and approving an acquisition.

Return to Text

n1 Delaware shareholders who wish to bring a derivative suit against a corporation must demand that directors of the corporation take action with respect to the alleged wrong, or they must show that such a demand would be futile.

n2 Although in the past Delaware courts have characterized the duty of good faith as a separate fiduciary duty, the Supreme Court of Delaware recently clarified that good faith is a subsidiary element, or condition, of the duty of loyalty. *Stone*, A.2d at 370. Thus, actions taken in bad faith breach the duty of loyalty. *Ryan v. Gifford*, 918 A.2d 341, 357 (Del. Ch. 2007).

n3 The presence of a conflict of interest will not automatically void a transaction under Delaware law. Section 144(a) of the Delaware General Corporation Code establishes a safe harbor for certain interested director transactions in three situations: (1) if the conflict of interest is disclosed to and approved by a majority of disinterested directors (even if they do not constitute a quorum); (2) if the conflict of interest is disclosed to and approved by shareholders; or (3) the transaction is fair as to the corporation as of the time it is authorized. Practitioners should note that the application of this rule is limited: satisfying the safe harbor only protects a transaction from *per se* voidability. Delaware courts will not automatically confer the protection of the business judgment rule on a transaction meeting the requirements of Section 144(a). *See Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 185 (Del. Ch. 2005).

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Stephen I. Glover is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher and a member of the firm's Corporate Transactions Practice Group. He has an extensive practice representing public and private companies in complex mergers and acquisitions, joint ventures, equity and debt offerings and corporate governance matters.

Mr. Glover has been ranked one of the top five corporate/commercial transactions attorneys in Washington, D.C. for the past five years (2005 - 2009) by Chambers USA America's Leading Business Lawyers. In August 2009 he was named as a finalist for the top Washington Corporate M&A lawyer by The Washington Business Journal. He was selected as the top Commercial/Corporate Transactions attorney in Washington, by The Washington Business Journal in their inaugural 'Top Washington Lawyers' Awards in September 2004 and was nominated for this award again in 2005 and 2007. Mr. Glover was named as a Leading Lawyer in US Mergers & Acquisitions in the 2008, 2007 and 2006 IFLR 1000 Guide to the World's Leading Financial Law Firms. In 2006, he was identified among "Ten of the D.C. Area's Top Deal-Making Attorneys" by Legal Times. He is the author or co-author of several books, including Business Separations Transactions: Spin-Offs, Subsidiary IPOs and Tracking Stock (revised 2009); Partnerships, Joint Ventures

and Strategic Alliances (revised 2009); and M&A Practice Guide (2008). He has written more than 60 articles and speaks frequently on corporate and securities law issues.

Renee M. Strandness is an associate in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP, where her practice focuses on public and private mergers and acquisitions, capital markets and other corporate transactions, as well as general corporate matters, including securities law compliance and corporate governance.

Ms. Strandness received her law degree in 2007 from Stanford Law School, where she served as an Executive Editor of the Stanford Law Review and as a Senior Editor of the Stanford Law & Policy Review. She received the Hilmer Oehlmann, Jr. Award for Excellence in Legal Writing and graduated with pro bono distinction. Prior to joining the firm, Ms. Strandness served as a law clerk for the Honorable Julia Smith Gibbons of the United States Court of Appeals for the Sixth Circuit. Ms. Strandness graduated *summa cum laude* with high honors in history from Vanderbilt University in 2004.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



3 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Aquila and Sawyer on Rights Plans

2010 Emerging Issues 5027

SPEED READING: TOP 10 ISSUES TO CONSIDER WHEN ADOPTING A RIGHTS PLAN

By Mr. Frank Aquila Esq. and Ms. Melissa Sawyer Esq.

May 10, 2010

SUMMARY: Rights plans are one of the most effective takeover defenses, despite the decrease in use over the past decade. This article focuses on ten key issues that any board should consider when making a decision relating to a rights plan.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: While rights plans, or "poison pills" as they are commonly known, are a frequent subject of litigation, with the exception of the recent *Selectica* situation in Delaware, rights plans are virtually untested. The fact that rights plans have not been tested in the heat of a takeover battle attests to their being among the most effective takeover defense ever developed. As a consequence of the effectiveness of rights plans, U.S. public companies adopted rights plans in increasing numbers in the late 1980s and throughout the '90s. In spite of, or maybe because of, their effectiveness, corporate governance watchdogs and activist institutional investors have increasingly opposed rights plans in recent years and, as a result, the number of U.S. companies that have rights plans has declined from more than 2,200 in 2001 to approximately 1,000 today.

Whenever a rights plan is adopted, it generates a significant amount of discussion among directors and their advisors. A complete survey of directors' fiduciary duties in relation to adopting a rights plan, or a detailed description of the mechanics of rights plans, would fill a much longer piece. Since fewer and fewer companies have rights plans in place, more boards will be faced with making decisions about adopting a rights plan in situations where a company may actually be facing an unwanted hostile bid. If presented with such a situation, anxiety levels will increase and "speed reading" will most certainly be required. This article focuses on ten key issues that any board should consider when making a decision relating to a rights plan.

1. Structuring an Optimal Board Process

A board's decision to adopt or maintain a rights plan is governed by the law of the state of the company's incorporation. If the company is a Delaware corporation, a board's action in adopting or maintaining a rights plan is entitled to the protection of the business judgment rule, which establishes a presumption that in making a business decision, the directors acted with due care (i.e., on an informed basis), in good faith and with the honest belief that the action taken was in the best interest of the company. The burden is on a plaintiff to establish facts rebutting the

presumption by a showing of fraud, bad faith, self-interest or lack of care on the part of the directors. The Delaware courts do, however, require that board actions that have antitakeover implications first satisfy an enhanced level of scrutiny before the courts apply the business judgment rule. Directors must first establish (i) that they had reasonable grounds for believing that there was a danger to corporate policy and effectiveness and (ii) that the measures they adopted were reasonable in relation to the threat posed. Despite this "enhanced scrutiny" requirement, however, Delaware courts have regularly upheld rights plans as "reasonable" defensive measures (whether they were adopted before or after a hostile bid emerged).

The adoption or maintenance of a rights plan therefore requires that directors (1) inform themselves about the rights plan, using the degree of care that an ordinarily prudent person would exercise under similar circumstances and (2) act in a manner that they believe is in the best interest of the company. Directors are entitled to rely in good faith on officers and employees if the board believes they are reliable and competent, on committees of the board if the board believes the committee merits confidence and on outside advisors if the directors believe the advice provided is within their professional or expert competence.

Recently, the Delaware Chancery Court issued a decision in the *Selectica* case. *Selectica v. Versata Enters.*, 2010 Del. Ch. LEXIS 39 (March 1, 2010). The court confirmed that the preservation of net operating losses ("NOLs") was a proper purpose for a rights plan. Perhaps more important than this narrow reading, however, is that the court signaled that directors have some discretion to determine what constitutes a proper purpose for a rights plan and how the company can design a customized plan to address its purpose. Therefore, the import of *Selectica* for M&A transactions is that if directors follow appropriate procedures, Delaware corporations can adopt rights plans that are designed to meet specific needs, such as responding to a hedge-fund hold-ups or issues presented by a particular hostile bidder, and not just implemented as generic anti-takeover devices.

If a board is considering adopting a rights plan, or is considering whether to maintain a rights plan in the face of a specific hostile offer, the board should develop a process for consideration of the issues that will satisfy the applicable state law requirements. In practice, this usually means the following:

- Receiving presentations from outside counsel regarding directors' fiduciary duties, the company's existing takeover defenses (if the rights plan is being adopted for anti-takeover purposes; see Section 2 below), the potential reactions of corporate governance watchdogs to the rights plan, considerations relating to the selection of a record date and payment date for the plan, and the other mechanics of the rights plan;
- Receiving presentations from a financial advisor about the company's stock price (if the rights plan is being adopted for anti-takeover purposes) and the appropriate range of exercise prices for the rights; and
- Receiving presentations from the Chief Financial Officer or other member of management regarding the magnitude of and potential for using the company's NOLs (if the rights plan is being adopted for NOL preservation purposes; see Section 2 below).

To build a strong record, it is usually advisable for a board to meet more than once (and preferably at least one of the meetings should be "in person" rather than telephonic) in connection with its consideration of the rights plan. In some cases, the board may also want its corporate governance committee to analyze the desirability of adopting a rights plan before the full board is asked to consider the plan. Elements of the board's "ordinary course" work will also be relevant to the board's deliberations (e.g., whether the company has a strategic plan and whether the company has done a market check for a change of control transaction). As always, it is critical that the company secretary maintain accurate records at any board meeting at which the board discusses a rights plan.

2. Types of Rights Plans: Takeover Defense v. NOL Preservation

The first step in considering the adoption of a rights plan is to decide what type of rights plan the company needs. Most frequently, rights plans fall into one of two buckets (although we may start to see more variety in the wake of the *Selectica* decision): (1) anti-takeover pills and (2) NOL pills.

Antitakeover pills typically have 15% or 20% thresholds and are designed to (1) deter abusive takeover tactics, including "creeping" acquisitions of control, (2) enhance the board's leverage to negotiate with a bidder and (3) buy the board some time to seek out alternatives if it does not think the unsolicited offer is in the company's best interests.

Even an anti-takeover rights plan, however, will not prevent an acquisition of the company at a full and fair price in a transaction that is in the best interests of the company.

NOL pills typically have 4.99% thresholds and are designed to preserve a company's NOLs by preventing shareholders from becoming "5% shareholders". The tax rules relating to NOLs are complex, but, simply put, changes in ownership of the company's stock by shareholders who own 5% or more of the company's shares (including as a result of certain capital raising transactions by the company) can imperil the company's ability to use its NOLs. Some company's NOLs are their most valuable asset and, in the *Selectica* case, the Delaware courts upheld the adoption of a rights plan to preserve NOLs.

3. Deciding Between Adopting a Pill Today or Putting a Pill "On the Shelf"

If a board decides a company needs an NOL pill, it should adopt it promptly. In contrast, if a company is considering adopting an antitakeover pill, it has two options: (1) it can adopt the pill immediately or (2) it can put a pill "on the shelf" (i.e., educate itself about the mechanics and other aspects of the rights plan and have all of the documentation drafted and ready to go in case an unsolicited bid emerges, but not actually adopt and announce a rights plan). There are pros and cons to each strategy, and in many ways the decision between these two options is very company-specific. However, some of the issues the board should consider include the following:

- How vulnerable is the company at this time (both in terms of its other available takeover defenses and in terms of where its stock is trading relative to its 52-week high and low trading prices)?
- Given the company's stockholder composition and the typical trading volumes in the company's stock, will the company be able to identify accumulations in its stock in time to implement a shelf pill effectively?
- Does the company have a predominantly institutional stockholder base that will be heavily influenced by RiskMetrics and other proxy advisory services that typically oppose the adoption of rights plans?
- Is the company likely to be a target of stockholder proposals requesting the termination of a poison pill?
- Is the company able to anticipate the exact kind of threat it is likely to receive? If not, it may be desirable to put a pill "on the shelf" that it can later customize to the particular facts and circumstances of a threat. This type of customization appears to be consistent with *Selectica*.

4. Stockholder Friendly Pill v. Traditional Pill

If a board decides to adopt a takeover defense pill immediately, rather than implementing a shelf pill, the board needs to decide whether the pill should be a so-called stockholder friendly pill. Stockholder friendly pills were developed in the decade in response to criticism of traditional pills by RiskMetrics and others. Certain of the key differences between stockholder friendly pills and traditional pills are as follows:

- Stockholder-friendly pills are typically required to be submitted to a stockholder vote within one year after adoption by the board. It is not always clear, in all cases, what impact the failure of the stockholders to approve the pill would have on its validity (in some cases, as a contractual matter, the rights plan provides that it expires automatically if the stockholders fail to approve it by a specified time).
- Stockholder friendly pills typically have much shorter terms (e.g., 3 years) than traditional pills (which often have ten-year or longer terms).
- Stockholder-friendly pills typically have a 20% trigger rather than a 15% trigger (the latter being the norm in the 1990s).
- Stockholder friendly pills typically have features that allow stockholders to vote to force a redemption of the pill if they favor an unsolicited takeover offer. These features can include, among other things, procedures for stockholders to compel the company's board to call a stockholder meeting for purposes of voting on the redemption of the pill.
- Stockholder friendly pills often have so-called TIDE ("three-year independent director evaluation") features that require independent directors to review the rationale for keeping the pill in place, even in the absence of a specific

unsolicited proposal. Many stockholder friendly pills require annual TIDE reviews (rather than triennial reviews that the "TIDE" acronym suggests).

RiskMetrics is less likely to criticize a stockholder friendly pill. The downside of a stockholder friendly pill, of course, is that it does make a company more vulnerable to an unsolicited takeover as follows: If the board refuses to redeem the pill to permit an unsolicited offer to proceed, the offeror can solicit stockholders to vote in favor of redeeming the pill. If the company has a staggered board, getting a single stockholder vote to redeem the pill will be less costly for the offeror than soliciting proxies to replace directors in two separate annual meetings for the purpose of having the board redeem the pill.

5. Dealing with Derivatives

In designing a rights plan, many companies struggle with the question of whether ownership of economic or voting rights in the company's stock through derivative positions should trigger the rights plan. Total return equity swaps are agreements between investors and a counterparty that give the investor the economic equivalent of owning a company's shares without actually transferring title to the shares. The parties have the ability to settle the swap in cash or shares. Accordingly, there was speculation for a time that an activist investor could enter into multiple total return swaps that could be settled on a single date in shares of the target without triggering any prior disclosure requirements. This would allow the activist investor to preserve the element of surprise, a powerful tool in any takeover battle.

The *Selectica* decision appears to clarify that directors can customize a rights plan to pick up derivative positions if the relevant legal standards are otherwise satisfied. For a number of reasons, however, it is usually not necessary to incorporate derivatives explicitly into the definition of beneficial ownership in a rights plan:

- The traditional broad definition of beneficial ownership that references Section 13(d) under the Exchange Act captures almost all situations that a company would ordinarily want to capture. After the *CSX* case and the SEC's investigations that followed, many activist hedge funds became aware that the "scheme to evade" language in Section 13(d) can be made to capture even total return swaps, and they have become more cautious about trying to use total return swaps to evade Section 13(d) disclosure requirements.
- It is virtually impossible for a company to track derivative positions that relate to its securities. The positions can go through multiple layers of "ownership" in one form or another, which would make it very difficult to determine if the pill has been triggered. In addition, actually implementing the pill, once triggered, would be even more difficult to do given the complex nature of tracking derivatives.
- Even if a company could identify problematic derivative positions, would it really want to (and would the court allow it to) "punish" the "innocent" institutional counter-party to the swap by triggering the pill and voiding the stock? Keep in mind that the activist investor who is accumulating positions through total return swaps does not actually hold the target's stock yet, so voiding the stock underlying the position only hurts the counterparty to the arrangement (and, to date, it does not appear that the "innocent" counterparties are negotiating for protection on this issue as part of their swap contracts). This could raise validity issues under state law as to whether voiding the counterparty's stock is a reasonable response to the threat posed (especially if an "innocent" institution is the plaintiff).

6. Working Through the Mechanics

As we said at the outset, the mechanics of rights plans are complex and a complete summary of how they work is beyond the scope of this article. Suffice it to say that it is important that the directors be well-informed concerning these mechanics. It is often helpful to supply a short term sheet or other summary of the rights plan's principal features and to walk the directors through a hypothetical takeover scenario to demonstrate how the rights plan would work in practice. Among other things, the directors should understand the purpose and basic structure of the "flip-in" and "flip-over" and what impact triggering those events could have on the company's stock.

7. Flip-Overs Provisions Under State Law

Rights plans for Delaware corporations can include "flip-over" provisions (which have the effect of diluting the acquirer's stock if the pill gets triggered but the acquirer takes a controlling stake in the target; in contrast, a "flip-in" provision only dilutes the acquirer's ownership of the target, not the ownership by acquirer's shareholders in the acquirer). Not all states, however, permit flip-overs. While all features of a rights plan should be vetted with local counsel, the "flip-over" feature deserves special attention to make sure it will work if the company is not incorporated in Delaware.

8. Exchange Features

The efficacy of a poison pill ultimately depends on the willingness and ability of stockholders to exercise the rights. To facilitate those exercises of the rights, many rights plans include provisions called the "exchange feature". Under these provisions, the company's board can allow rights holders to exchange rights for common stock on a one-for-one basis. This reduces the dilutive effect of the pill, but has the beneficial effect of eliminating the need for stockholders to pay the exercise price in cash. In addition, some rights plans include a concept that allows the exchange feature to be administered by an independent trustee in an orderly fashion. Ideally, the trustee concept obviates the potential market disruptions that could follow from stockholders trying to exercise rights. In the Selectica situation, for example, the target's stock ceased trading for an extended period while its transfer agent attempted to sort out who was entitled to exercise rights at what time.

9. How to Set the Exercise Price

Customarily, exercise prices range from three times to five times the company's current market price. However, an investment bank can provide a more detailed rationale for the exercise price determination for any particular company. In particular, an investment bank could analyze comparable companies rights plans, comparable types of rights plans (even if the companies adopting the plans are not comparable companies), future share price analyses based on trading multiples, and a capital asset pricing model. An investment bank can also advise the board which methodologies are most appropriate given a company's particular facts and circumstances and what the purchases of the rights plan are.

10. Dealing with the Details: Overprinting, Stock Exchange Rules and SEC Filings

The timeline for adoption of a rights plan needs to take account of a number of technical details, including the following:

- Rights initially trade with the common stock and are evidenced by a legend printed on the stock certificate. For companies that have few, if any, certificated shares, the stock certificates are typically held in a vault at the company's transfer agent. If the company is adopting a rights plan for the first time, it needs to have the rights legend printed on its stock certificates for the first time. If it is adopting a second rights plan, it may be able to "over-silver" a new legend on top of the old rights legend on its stock certificates. If the Company is adopting a third rights plan, it may be necessary for the company to have all new stock certificates printed.
- The stock exchanges have certain requirements associated with the adoption of a rights plan. For example, the New York Stock Exchange requires that the company submit a listing application for the rights and give notice of the record date for the issuance of the rights. It is advisable to coordinate with a representative of the relevant exchange early in the process to ensure compliance with all of these technical requirements well in advance of the desired effective date for the rights plan.
- The rights issued pursuant to a rights plan also need to be registered under the Exchange Act, which can be accomplished by filing a Form 8-A with the SEC. If the company has an existing rights plan that is expiring, it will also be necessary to delist and deregister the company's old, expiring rights.

* * *

Despite a decade in which pressure from corporate governance watchdog groups and institutional shareholders has dramatically reduced the number of rights plans currently in place at U.S. public companies, the rights plan remains the

most effective takeover defense available to most companies. The recent Delaware Chancery Court *Selectica* decision validates rights plans as an appropriate tool available to boards of directors seeking to protect legitimate corporate interests in a manner that is consistent with their fiduciary duties. Rights plans may be under siege, but when the corporate bastion is under siege the rights plan continues to be one of the best defenses.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ABOUT THE AUTHOR(S):

Frank Aquila is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. His practice focuses on mergers, acquisitions, strategic alliances and corporate governance matters for large multinational corporations. Mr. Aquila was an American Lawyer "Dealmaker of the Year" in 2009 and is the 2010 recipient of the Atlas Award as the "Global M&A Lawyer of the Year." Mr. Aquila has also received Burton Awards for Legal Achievement in 2005 and 2010. He received his A.B. degree from Columbia University and his J.D. degree from Brooklyn Law School.

Melissa Sawyer is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. Her practice has focused on a variety of corporate, M&A and private equity matters in the U.S. and abroad. Ms. Sawyer was featured in "The Facebook of Wall Street's Future" (New York Times, October 3, 2007) as one of Wall Street's "next generation of deal makers." She received her B.A. degree from Washington & Lee University and her J.D. degree from the University of Virginia Law School.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



4 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Issues in a Public Company Merger Agreement

2010 Emerging Issues 4883

Speed Reading: Ten Issues to Spot in a Public Company Merger Agreement

By Mr. Frank Aquila Esq. and Ms. Melissa Sawyer Esq.

February 19, 2010

SUMMARY: Review of a merger agreement often needs a quick turnaround. This commentary focuses on 10 key issues that give deal teams a sense of whether a deal is achievable and can form the basis for an easy-to-digest comparison of competing bids on an expedited basis. Most issues focus on price and closing certainty and tend to require negotiation among the principles.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Public company merger agreements regularly exceed 60 pages. Yet, clients often need feedback within hours of receiving the first draft. Is it possible to provide any meaningful guidance on an expedited basis? Although every deal is different, and every merger agreement requires a close read, any initial review of a draft merger agreement should focus on ten key issues. Most of the key issues relate to price and closing certainty, and focusing on these ten issues will give the deal team a sense of whether reaching a deal is achievable. These ten issues also can form the basis for an easy-to-digest comparison of competing bids.

1. Merger Consideration

Usually the first draft of a merger agreement does not include dollar amounts or a specific exchange ratio. Often this is because those matters have not yet been agreed, because the parties do not want to increase their risk of a leak of the valuation or because the parties do not want to trigger a disclosure requirement by documenting an agreed price. Even in the absence of specific price information, a quick read of the merger consideration provisions in the merger agreement can provide valuable information, including the following:

What is the proposed form of consideration (cash, stock, mixed or other)?

If stock consideration is proposed, is the exchange ratio fixed or floating? Are there any collars? Are there built-in dilution adjustments? Are there any other adjustments (for example, if the draft contemplates a fixed exchange ratio based on the parties' relative tangible book values, what is the mechanism for "bringing-down" those valuations at closing, if any)?

If mixed consideration is proposed, is there a cash election or pro rata allocation mechanism?

Are there any built-in purchase price adjustments? Are the adjustments pre-closing or post-closing? If post-closing, is there an escrow or a holdback?

What is the proposed treatment of preferred stock, stock options, restricted stock units, share appreciation rights, warrants and other securities (e.g., cash out v. roll-over)?

In addition to spotting business issues associated with the merger consideration calculations, a quick read of the merger consideration provisions will also identify critical structuring issues, such as whether a target's preferred stock and equity awards can be cashed-out in a deal without the consent of the holders and whether a proposed cash-election mechanism is permissible under the proxy rules.

2. Deal Protections

For a variety of reasons, Delaware law virtually requires that the parties engage in some back-and-forth negotiations regarding deal-protections, which include no-shops, change in recommendation provisions and break-up fees. Key issues to identify include the following:

Does the no-shop include a reasonable fiduciary out?

Can the target provide due diligence access to an interloper that has made a potential superior proposal if the interloper signs a confidentiality agreement (excluding a standstill)?

Does the buyer have a matching right if the target receives a superior proposal?

How do the notification requirements and time periods associated with the receipt of a superior proposal work? Do they give the target's board enough time and information for the directors to comply with their fiduciary duties?

Can the target's board change its recommendation both for a superior proposal and in an "oil under the headquarters" scenario? Even if the target's board changes its recommendation, is there a "force-the-vote" (a contractual requirement that the approved deal be put to a shareholder vote no matter what happens after the deal has been agreed)?

How much is the break-up fee? Is there an additional provision for payment of expenses? Under what conditions are these fees payable? Is there a "naked no-vote" fee?

Are there any other deal protections (e.g., stock options or crown jewel options)?

If the buyer requires a shareholder vote, is the buyer subject to any deal protections?

Is there a go-shop?

3. Financing; Reverse Break-Fees; Specific Performance

How the buyer intends to line up its financing (and the question of what happens if the financing arrangements fall apart before the closing) is critical. This issue arises in cash deals in which a portion of the purchase price will be financed by third party lenders and in stock-for-stock deals in which either or both parties' existing debt will need to be refinanced to address change in control puts, ratings conditions, dividend stoppers or other restrictive covenants in the existing debt agreements.

If the buyer intends to use cash "on hand" to pay the purchase price, usually a representation and warranty that the buyer has the requisite cash available is satisfactory if it is coupled with due diligence regarding the buyer's cash position and a covenant that buyer will not take any actions between signing and closing that would cause that

self-financing to become unavailable.

If the buyer requires third party financing, the ideal situation from a target's perspective is to get firm commitments from the lenders at the signing. These could take the form of U.K.-style "funds certain" commitment letters or fully documented and executed loan agreements. In practice, however, it is often not realistic to lock-in all of the details of the financing pre-signing.

In those cases where there is some uncertainty regarding financing, the parties need to allocate the risk of a failure to obtain the financing. That risk allocation involves a few key concepts: (1) the level of efforts the parties are required to take to secure the requisite financing; and (2) the consequences of a failure to obtain the requisite financing when all other closing conditions have been satisfied.

Level of Efforts to Obtain Financing. Merger agreements often include covenants that address the extent to which the buyer is required to incur costs to obtain its financing. The parties should give some thought to which buyer entity is bound by the provision (e.g., in a private equity deal, is it the fund, a guarantor or the shell acquisition vehicle?). The provision may address whether there will be a pre-closing marketing period during which the buyer can work with its primary lender to syndicate some of the debt. The merger agreement may also address whether the target is required to provide audited financial statements or solvency certificates or cause its management to participate in lender-oriented road-shows.

Consequences of Failure to Obtain Financing. This has been a hot topic in the M&A literature and much has been written regarding the relationship between specific performance provisions, reverse-break-up fees, financing conditions and the availability of damages calculated by reference to loss of market value. Suffice it to say that all of these concepts require close attention and may end up being the most contentious issue in a deal negotiation (after price). As we learned from the *United Rentals v. Cerberus* case, careful attention to detailed drafting on these issues is a must, but even a quick glance at a merger agreement can inform the reader whether the buyer's approach to conditionality is consistent with the seller's.

4. Social Issues

Social issues are issues that relate to the governance and conduct of business of the combined company following an M&A transaction. These issues are most relevant to a stock-for-stock transaction, especially a merger of equals, where each parties' shareholders have an economic interest in how the combined company is run (in contrast to a cash merger in which the target's shareholders will not have any continuing interest in the combined company).

Social issues include the following:

Composition of the combined company's board of directors;

Composition of the combined company's executive management;

Location of the combined company's headquarters;

Name of the combined company; and

Treatment of the target's employees (e.g., continuation of salary and benefits).

Fortunately, social issues are usually easy to spot in a draft merger agreement. Unfortunately, they are not so easy to resolve!

5. Reciprocity of Representations and Warranties and Interim Covenants

In cash mergers, the buyer usually makes very few representations and warranties in the merger agreement (other

than basic transactional and financial solvency representations and warranties). In a cash deal, the buyer is also unlikely to agree to many restrictions on its conduct of business between signing and closing (other than, perhaps, a restriction on taking any action that would cause it to be unable to close the transaction). In contrast, in a stock-for-stock merger, it is customary for a buyer to provide more representations and warranties, just as it is customary for the buyer to give the target more access to perform due diligence on the buyer, for purposes of validating the value of the buyer's stock. It is also customary for the buyer to agree to restrictions on its interim conduct of business, especially if the buyer requires shareholder approval for the transaction. The more the transaction appears to be a merger of equals in which the buyer and the target are equal in size, the more likely it is that the buyer's and the target's representations and warranties and interim covenants will mirror each other. A quick read of a public company merger agreement can reveal whether the drafters approached a deal as a merger of equals.

6. MAEs: Definitions, Bring-Downs and Standalone Conditions

"Material adverse effect" provisions ("MAEs") always have been a hot topic for M&A practitioners. Any quick-read of a merger agreement should identify the following:

Whether the MAE definition and carve-outs are customary;

Whether MAEs are used appropriately to qualify representations and warranties;

Whether the "absence of changes" representation and warranty includes a MAE qualifier and whether the representation is "brought down" at closing (with attention to "double materiality" issues);

Whether there is a stand-alone MAE closing condition and, if so, whether it refers back just to the signing date or to the last audit date, and whether it can be qualified by reference to the disclosure schedules; and

Whether and under what conditions the parties have termination rights if a MAE occurs.

Recent cases, such as *Huntsman v. Hexion*, have continued the Delaware courts' perfect record of never finding that a MAE has occurred. That is not to say, however, that MAE clauses have no value. The absence of case law may reflect that parties seeking to exercise outs are successful in doing so on a negotiated basis (or in the settlement of litigation). Accordingly, careful attention to MAE drafted is still warranted.

7. Hell or Highwater Provisions; Drop-Dead Dates

Inextricably linked with regulatory approval closing conditions are "hell or highwater" provisions. These are covenants that specify the level of efforts a party is required to undertake in order to obtain requisite regulatory approvals (and, in some deals, requisite third party consents). Key concepts include the following:

Whether either party is required to agree to divestitures, hold separate orders, consent decrees or other restrictions and, if so, whether there is any "cap" on that obligation;

If there is such a cap, is the cap measured by reference to a specified quantitative threshold or by reference to some notion of materiality measured against the target, the buyer or the combined company, with or without taking into account the transaction synergies?

Is either party required to litigate to seek to have an adverse regulatory determination over-turned? If so, must the party pursue such litigation to the highest possible court or is it sufficient to have an adverse determination at a lower court level before the parties can part ways?

What is the drop-dead date on the deal? Does it give sufficient time to obtain the requisite regulatory approvals? Does either party have the right to extend the drop-dead date for regulatory reasons?

By when are the parties required to make all regulatory filings?

To what extent must each party cooperate with and involve the other party in discussions with regulators regarding requisite approvals?

8. Other Closing Conditions

Flag any non-standard closing conditions in a preliminary issues list. The menu of possibilities is virtually endless, including ratings conditions, conditions that specified employees be employed at the closing, minimum EBITDA and other performance-related conditions, conditions related to specified litigation matters, and conditions related to specified regulatory hurdles. Some conditions that, on their face, appear to be customary may contain traps for the unwary. For example, pay close attention to (1) any "flat" bring-down requirements (i.e., bring-down language that is not subject to MAE or other materiality qualifiers) that could be difficult to satisfy and (2) regulatory conditions relating to non-material regulatory approvals or filings. It is also important to focus on which party has the right to claim a condition has not been satisfied. Not all conditions need to be mutual but sometimes one can find surprising instances of one-sidedness in first drafts of merger agreements.

9. D&O Indemnity and Insurance

The director and officer ("D&O") indemnity and insurance provisions of a public company merger agreement are easy to overlook. They usually comprise only a few paragraphs. However, they frequently get a lot of attention from the target's directors. Key considerations include:

Is there a post-closing indemnity for the target's directors' and officers' pre-closing activities? If so, which entity is providing the indemnity (the target, the buyer or other)? Is the scope of the indemnity the same as, or greater or less than, what a corporation is allowed to provide to its own directors and officers under state law?

Is the buyer required to preserve the target's existing indemnities contained in its bylaws? Would this requirement survive a change of control of the buyer or the surviving corporation?

Is the buyer or the target required to purchase a tail policy to protect the target's directors and officers for pre-closing actions? What is the cap on premiums? Is it a Side A policy? Are the directors and officers required to seek recovery from the tail policy before seeking indemnification from the company?

Do the target's directors and officers have third party beneficiary rights to enforce the D&O indemnity provisions?

10. Tax Structure of Merger

Usually a merger agreement's recitals will reveal quickly whether the transaction is intended to be structured as tax-free or taxable to the target's shareholders. A tax specialist can verify which structure (forward, forward triangular, reverse triangular, multi-step, etc.) will achieve the desired tax treatment given the facts. The key is to make sure that the tax specialist did indeed have the relevant facts. For example, factors like the form of merger consideration and the existence of preferred stock roll-overs could impact the tax structure analysis. While these structural issues usually are not very contentious, they can require a lot of work and collaboration between the parties to develop appropriate solutions. For that reason, it is best to identify them as soon as possible and task a joint working group with fixing any disparities between the desired tax treatment and the manner in which the corporate drafts-person envisioned the transaction would be structured.

Conclusion

Public company merger agreements are complex documents that combine multiple, intersecting layers of business and legal issues. In any initial review of a draft merger agreement it is imperative that you not miss the forest for the

trees. Fortunately, practices have evolved such that many sections of these agreements are virtually "boilerplate". Unless one party is particularly wedded to its own form, it is often just a matter of making sure those "boilerplate" sections actually work under the applicable facts and comply with the applicable rules, regulations and governance documents. The ten issues we outlined above, however, are not "boilerplate". They tend to be more contentious and require negotiation among the principles. They are also the sorts of issues that a board of directors usually should discuss in connection with considering whether to approve a transaction. M&A lawyers should be able to identify these issues quickly and accurately (not to mention propose ways to bridge gaps in the parties' respective positions). The sooner the principals are informed of these issues, the sooner they can negotiate any differences and get the deal announced before there is a leak or a party changes its mind.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Frank Aquila is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. His practice focuses on mergers, acquisitions, strategic alliances and corporate governance matters for large multinational corporations. Mr. Aquila was lead outside counsel to InBev in connection with its successful unsolicited acquisition of Anheuser-Busch. Mr. Aquila received a Burton Award for Legal Achievement in 2005. He received his A.B. degree from Columbia University and his J.D. degree from Brooklyn Law School.

Melissa Sawyer is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. Her practice has focused on a variety of corporate, M&A and private equity matters in the U.S. and abroad. Ms. Sawyer was featured in "The Facebook of Wall Street's Future" (New York Times, October 3, 2007) as one of Wall Street's "next generation of deal makers." She received her B.A. degree from Washington & Lee University and her J.D. degree from the University of Virginia Law School.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



5 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Tom, Reddy & Spaeth on "Entire Fairness" in Cede & Co.

2009 Emerging Issues 4458

Roslyn Tom, Neil Reddy and Edward J. Spaeth on "entire fairness" in Cede & Co. v. Technicolor

By Ms. Roslyn Tom Esq., Mr. Neil T. Reddy Esq. and Mr. Ed Spaeth Esq.

October 12, 2009

SUMMARY: The courts will use the standard of "entire fairness" to evaluate the decisions of a board where the plaintiff has rebutted the presumption of the business judgment rule by proving a breach of fiduciary duties. This Emerging Issues Analysis discusses the ruling in *Cinerama, Inc. v. Technicolor, Inc.* and provides practice tips to assist boards in making decisions under the "entire fairness" standard.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Roslyn Tom, Neil Reddy and Edward J. Spaeth on "entire fairness" in Cede & Co. v. Technicolor n1

Article: In Delaware, courts will initially review the decisions of a board of directors under the standard of the business judgment rule. Under this standard, the Delaware courts will defer to the decisions taken by the board members unless the plaintiff can meet its burden of proof for overcoming the business judgment rule's presumption of the board's duty of care. From a procedural perspective, the demonstration by the plaintiff of the breach of any one of the board's fiduciary duties-duty of care, loyalty or good faith -would be sufficient to shift the burden of proof to the board of directors to demonstrate entire fairness. Pursuant to the entire fairness standard, the directors must prove to the court that the transaction was the result of both fair dealing and fair price. n2

In *Cinerama, Inc. v. Technicolor, Inc.* n3, the Delaware Supreme Court held in the case of a sale transaction where the stockholder plaintiff has proven a breach of fiduciary duties by the directors, the Court must review the transaction under the entire fairness standard. The entire fairness standard requires the directors to demonstrate that the transaction was the product of (1) fair dealing and (2) fair price. The Court will look at both of these factors in conjunction in order to determine the entire fairness of the transaction.

Technicolor involved the acquisition of Technicolor, Incorporated ("Technicolor") by MacAndrews & Forbes Group, Incorporated ("MAF") through a tender offer and subsequent cash-out merger, where Technicolor would be merged into a wholly-owned subsidiary of MAF. Pursuant to the terms of the tender offer and cash-out merger, Technicolor's shareholders were offered \$23 per share. n4 MAF also negotiated stock purchase agreements with Morton Kamerman, CEO and a director of Technicolor, and Guy Bjorkman, a director and the largest stockholder of Technicolor, who together owned 11% of Technicolor's stock. In addition, MAF received an option to acquire 18% of the authorized but unissued stock of Technicolor in the event another buyer offered a higher price for Technicolor,

which, in combination with the stock purchase agreements plus MAF's 4.8% ownership of Technicolor stock, would give MAF control of approximately 34% of Technicolor's outstanding stock. Kamerman also negotiated a revised employment agreementⁿ⁵ for himself and, subject to the completion of the transaction, a finder's fee for Fred Sullivan, the Technicolor director who had introduced MAF to Kamerman.

After the terms of the agreements and the price had been agreed upon with MAF, Kamerman called a meeting of the Technicolor directors. Six of the nine directors were considered independent. Besides Kamerman and Sullivan, an additional director, Arthur Ryan, COO of Technicolor, had learned of the transaction and believed he would be promoted by MAF. Kamerman described the details of the transaction and disclosed his and Sullivan's interest in the transaction. The board also received presentations about the details of the transaction, including the fairness of the price, from their outside legal counsel and investment bank advisors. At the end of that meeting, the board approved the transaction and the various agreements.

Shortly thereafter, MAF commenced its tender offer for the shares of Technicolor and subsequently completed the acquisition with a second-step merger. A dissenting Technicolor shareholder, Cinerama, Inc. ("Cinerama"), petitioned the Delaware Court of Chancery for appraisal of its shares and later filed an additional suit against the directors of Technicolor for, inter alia, breach of fiduciary duty and unfair dealing.ⁿ⁶ In subsequent proceedings on appeal, the Supreme Court found that the board had breached their duty of care by not being reasonably informed and, therefore, Cinerama had rebutted the presumption of the business judgment rule.ⁿ⁷ As a result, the case was remanded to the Court of Chancery which was required to apply the entire fairness standard to the transaction.

On remand, the Chancery Court reviewed whether the board had breached its fiduciary duty of loyalty as part of its entire fairness review. The Court of Chancery reviewed Cinerama's breach of loyalty contentions within the substantive context of the fair dealing component of its entire fairness analysis. A determination that the directors had breached the duty of loyalty in dealing with the shareholders might prevent a finding of entire fairness. In its examination, the Chancery Court found that the board as a whole did not breach its duty of loyalty, as the majority of the board was disinterested and independent with respect to the transaction and the interested directors neither dominated nor manipulated the board in its consideration of the transaction.ⁿ⁸ The Supreme Court affirmed this decision on appeal.ⁿ⁹

In affirming the Chancery Court's findings on entire fairness, the Supreme Court explained that the rebuttal of the presumption of the business judgment rule by the plaintiff did not create per se liability for the board; instead, such rebuttal shifted the burden of proof to the board to demonstrate the entire fairness of the transaction.ⁿ¹⁰ In order to meet this burden of demonstrating the entire fairness, the Supreme Court explained that the director defendants must show that the transaction reflected both fair dealing and a fair price. The Supreme Court also explained that in order to establish the entire fairness of the transaction, these components must be tested on a non-bifurcated basis, and that all aspects of the issue must be examined as a whole since the question is one of entire fairness. The Supreme Court then reviewed the entire fairness analysis of the Chancery Court.

Fair Dealing

In analyzing whether there was fair dealing in the transaction, the Supreme Court listed the following factors to be considered when analyzing fair dealing: "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."ⁿ¹¹

Timing and Initiation of the Transaction

First, with respect to the timing of the transaction, no issues were raised. The Supreme Court commented that that in the case at hand, no fiduciary manipulated the timing of the transaction to benefit itself at the expense of stockholders. The Supreme Court did not find that that the MAF transaction was unfairly initiated, as MAF was an independent third party (as opposed to a controlling stockholder) with no power to force the initiation of a deal.

Negotiation of the Transaction

The Supreme Court indicated that an arm's-length negotiation provides strong evidence that the transaction meets the test of fairness. In the case at hand, the Supreme Court found that the Technicolor negotiators were able to bargain the price from an initial \$15 to the final \$23. In addition, Technicolor shareholders had the benefit of an independent and disinterested board, with six of the nine directors being independent. The Supreme Court also noted that Sullivan was the only director that had a material conflict (the receipt of a \$150,000 finder's fee), and that Sullivan fully disclosed that interest to the disinterested members of the board, and the contract was thereafter approved by them.

Structure of the Transaction

Another factor of fair dealing is whether the transaction was structured in a way that permitted alternative bids to be made, as a transaction that was "locked up" with no termination right would be unfairly structured. In the Technicolor transaction, the Supreme Court found that while the "no-solicitation" clause prohibited the board from soliciting other bids, it was not prohibited from providing information to and engaging in discussions with competing bidders.

Disclosure to Directors

The Supreme Court articulated that the process of board consideration and approval must be considered in determining entire fairness. One must first consider whether the interests of any of the directors were disclosed to the board. The duty of disclosure is based on a materiality standard. The Supreme Court concluded that the material facts regarding the finder's fee to be paid to Sullivan and its contingency on the acquisition being consummated were disclosed, and a majority of the non-interested directors approved the transaction in good faith.

Approval by Directors

The Supreme Court emphasized that the degree of procedural due care a board of directors exercises is a continuing component of an entire fairness analysis. The process that the board undertakes in considering and approving a transaction must be weighed in determining entire fairness. Cinerama claimed that the lack of care in making a market check was a flaw in the approval process by the board. However, the Supreme Court deferred to the findings of the Court of Chancery. The Court of Chancery determined that, in light of the board's good faith and arm's-length negotiations, its decision to approve the MAF proposal without making a market check, while clearly deficient, did not preclude a finding of entire fairness. In making its determination, the Court of Chancery considered that the Technicolor board: had carefully focused on whether the MAF bid offered the best price available in a sale of the company; had considered whether to shop the company and the risks that course would entail; possessed a substantial amount of prior knowledge pertinent to the decision to sell; and relied on the reports of Kamerman, Goldman Sachs, its financial adviser, and its outside legal counsel.

Disclosure to Shareholders

The Supreme Court stated that another well-recognized aspect of fair dealing was the board's duty of disclosure to the shareholders. While compliance with the disclosure duty is not, in and of itself, determinative of entire fairness, it does have persuasive substantive significance. First, it removes the case from the virtual per se rule of damages for breach of the fiduciary duty of disclosure. Second, it bears directly upon how the shareholders' approval was obtained. Third, it places the transaction into the category of a non-fraudulent transaction, wherein the Supreme Court has recognized that price would be the preponderant consideration outweighing other features of the merger. The Supreme Court agreed that in the case at hand, there was no merit in any of Cinerama's disclosure claims.

Approval by Shareholders

Finally, the Supreme Court stated that where a majority of fully informed shareholders ratify the action of

interested directors, such approval is substantial evidence of fairness. In the Technicolor transaction, the Supreme Court indicated that in the absence of a disclosure violation, the Court of Chancery properly found the tender by more than 75% of Technicolor's shareholders to be tacit approval of the transaction and substantial evidence of fairness.

Fair Price

In addition to fair dealing, the other major component of the entire fairness standard is fair price. The Supreme Court explained the factors to be used when analyzing fair price—the "economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic value of a company's stock." n12 The Supreme Court found the following factors to be significant in determining that the price paid constituted the highest value reasonably available to the Technicolor shareholders. First, MAF paid a significant premium over the market price. Second, Technicolor's senior management accepted MAF's bid and declined to pursue a competing buy-out. Third, the Court of Chancery found the fact that the major shareholders, including Kamerman and Bjorkman, who had the greatest insight into the value of the company, sold their stock to MAF at the price paid to the other shareholders, which lends weight to the view that the price received was fair. Fourth, the Supreme Court indicated that the fairness opinion given by Goldman Sachs was another consideration to support a finding of fair price. Lastly, the Supreme Court noted that no compelling evidence of a higher price was provided and there were no rival bidders. Based on this evidence, the Supreme Court found that the deal price was the highest price reasonably available.

Entire Fairness Determination

In reviewing the transaction as a whole, the Supreme Court found that the board's gross negligence in making an uninformed decision to approve the transaction and its failure to make a market check was outweighed by the board's fulfillment of its other duties. As a result, the Supreme Court affirmed the Chancery Court's holding that the price achieved and the process followed by the board was entirely fair to Cinerama with respect to both the tender offer and cash-out merger.

The Supreme Court weighed the finding of the board's gross negligence in failing to conduct a market check, against the other findings concerning the board's proper conduct. The Supreme Court indicated that the Court of Chancery meticulously considered and weighed each aspect of fair dealing and fair price that the board had properly discharged, in accordance with its fiduciary duties, against the board's failure to test the market. After finding that the price obtained was the highest price reasonably available, the Court of Chancery concluded that the transaction was entirely fair.

The standard of entire fairness is not a bright line analysis but a disciplined balancing test that must take into account all relevant factors in the situation at hand. While the Technicolor case involved a third-party bidder and claims of self-interested directors, the analysis is similar in transactions involving controlling shareholders. In both situations there may be claims of self-dealing by such insiders, and the standard of review in such scenarios generally is that of entire fairness, with the defendants having the burden of persuasion.

Under these circumstances, a board can consider the following methods to avoid the shifting of the burden of proof from the plaintiff to the board and to assist the board in proving entire fairness should the burden shift to the board:

- Have a well-informed and well-functioning committee of independent directors to provide evidence of an arms-length negotiation of the transaction;
- Retain separate legal counsel to the independent directors;
- Retain financial advisors and obtain a fairness opinion with respect to the consideration being offered by the bidder;
- Document the process taking place in respect of the solicitation of and meeting and negotiation process with potential bidders;

- Conduct a market check in respect of possible bidders across both financial and strategic buyers, or consider a "go shop" clause after the signing of an acquisition agreement in the event the market check prior to signing the acquisition agreement may not be sufficient;
- Besides providing a "fiduciary out" in the acquisition agreement so that the board can continue to entertain competing offers, ensure that the deal protection clauses, including termination fees and topping bids, requested by the bidder are not so unreasonable so as to have a chilling effect on competing bids;
- Make full disclosure of any competing interests or related party transactions to the members of the board and to shareholders; and
- In deals involving a controlling shareholder, obtain the consent of a majority of the minority shareholders.

These and the other considerations indicated in the Technicolor case are factors that a board can consider in advance when confronted with a sale transaction involving potential conflicts of interest.

Additional Resources

For more on mergers and acquisitions, see M&A Practice Guide.

For more on board fiduciary duties, see Liability of Corporate Officers and Directors and Delaware Corporation Law and Practice.

[Return to Text](#)

n1 See *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988) ("*Technicolor I*"); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), modified, 636 A.2d 956 (Del. 1994) ("*Technicolor II*"); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134 (Del. Ch. 1994), *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995) ("*Technicolor III*"); *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996) ("*Technicolor IV*"); *Cede & Co. v. Technicolor, Inc.*, 758 A.2d 485 (Del. 2000) ("*Technicolor V*"), *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26 (Del. 2005).

n2 *Weinberger v. UOP, Inc.*, 457 A.2d 701,711 (Del. 1983).

n3 *Technicolor III*, 663 A.2d 1156.

n4 Two months prior to the announcement of MAF's offer, Technicolor's stock had traded at a low of \$8.37.

n5 The revised employment agreement guaranteed Kamerman's salary for the 5-year term of his agreement and increased the annual compensation for the 5-year consulting agreement, which began upon his termination, from \$100,000 to \$150,000.

n6 The litigation in this case began in 1986, when Cinerama voted against the merger, petitioned for an appraisal of its shares, and filed suit against Technicolor's directors for breach of fiduciary duty and unfair dealings, among other claims. The Court of Chancery originally ruled that Cinerama would have to elect which cause of action it wanted to pursue—the appraisal action or the liability action; this finding was reversed in an interlocutory appeal to the Supreme Court of Delaware, which found that Cinerama was entitled to concurrently pursue both the appraisal action and the liability action. *Technicolor I*, 542 A.2d at 1192. In 1991, the Court of Chancery found that even if there were persuasive evidence that Technicolor's board had not exercised due care, Cinerama failed to prove it had been damaged. *Cinerama, Inc. v. Technicolor, Inc.*, 1991 Del. Ch. LEXIS 105 (Del. Ch. June 21, 1991). The Supreme Court of Delaware affirmed in part, but remanded the case to the Court of Chancery for an application of the entire fairness standard to the transaction. *Technicolor II*, 634 A.2d at 351. On remand, the Court of Chancery found that Technicolor's board met its burden of demonstrating the entire fairness of the transaction, and entered judgment in its favor on the liability action. *Cinerama Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1144 (Del. Ch. 1994). On a third appeal, the Supreme Court of Delaware found sufficient evidence to support the Court of Chancery's finding that \$23 per share was the highest price reasonably available, and affirmed the ruling in favor of the board. *Technicolor III*, 663 A.2d at 1177. This ruling is described in the subject of this article. The ruling on the liability action left only the appraisal action to be settled. Subsequent rulings settled the issues of the correct discount rate and amount of corporate debt to apply in the formula for determining Technicolor's per share value, and the appropriate interest rates to apply in entering judgment for Cinerama. See *Technicolor IV*, 684 A.2d 289; *Technicolor V*, 758 A.2d 485; *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26.

n7 *Technicolor II*, 634 A.2d 345.

n8 *Technicolor III*, 663 A.2d 1134.

n9 *Technicolor III*, 663 A.2d 1156.

n10 *Technicolor III*, 663 A.2d 1156.

n11 *Weinberger*, 457 A.2d at 711.

n12 *Weinberger*, 457 A.2d at 711.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ABOUT THE AUTHOR(S):

Roslyn Tom is a Partner at Baker & McKenzie LLP in New York. Ms. Tom specializes in both public and private mergers and acquisitions and domestic and international securities offerings, including SEC-registered offerings and NYSE listings. She has represented acquirers, targets, purchasers, sellers, issuers, underwriters, creditors and debtors in a variety of industries in US and cross-border transactions. Ms. Tom has represented private equity funds in complex out-of-court restructurings of their portfolio companies. Ms. Tom also represents multinational companies in corporate restructurings involving multiple jurisdictions in Asia, Europe and Latin America.

Neil T. Reddy is an Associate at Baker & McKenzie LLP in New York. Mr. Reddy specializes in mergers and acquisitions, private equity and corporate counseling and governance.

Ed Spaeth is Vice President and Lead Content Acquisition & Publishing Counsel at LexisNexis. Mr. Spaeth's practice focuses on all aspects of publishing law and information and database licensing, including both licensing of information for use by LexisNexis and licensing of information owned by Reed Elsevier Inc. to third parties. Mr. Spaeth is the legal business partner for the Research Litigation & Business Information Solutions Organization, Editorial and Content Development and USLM licensing.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



6 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Thompson and Schwartz on Arnold and Change of Control

2009 Emerging Issues 4391

Thompson and Schwartz on the Application of the Revlon Duties in a Merger Transaction that Does Not Involve a Change of Control

By Mr. Kenneth R. Thompson II Esq. and Mr. Michael G. Schwartz Esq.

October 2, 2009

SUMMARY: In *Arnold v. Soc. for Savings Bancorp, Inc.*, the Delaware Supreme Court held that the duty imposed on directors by Revlon, to "seek the best value reasonably available to the stockholders," doesn't apply in a stock-for-stock merger transaction with no change of control, and that Delaware courts will review directors' approval of such a transaction under the customary business judgment rule rather than the "enhanced scrutiny" standard of review.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Introduction

In 1986, the Delaware Supreme Court issued its seminal *Revlon* decision, holding that corporate directors have a fiduciary duty to obtain the best price for the company's stockholders when the company embarks on a transaction that will either break up the company or will result in a change of control. Following the *Revlon* decision, the Delaware judiciary has examined the application of these *Revlon* duties in a variety of circumstances including stock-for-stock mergers.

The Development of Enhanced Scrutiny in Delaware.

The application of enhanced judicial scrutiny in corporate change of control transactions arose out of two cases decided by the Supreme Court of Delaware in 1985 and 1986. These cases, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), and *Revlon Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173 (Del. 1986), changed the landscape of how directors of Delaware corporations approach their roles in change of control situations. From the shareholder's perspective, enhanced judicial scrutiny is warranted due to the inevitable risk during a corporate change in control that a board may be acting in its own interest, and not in that of the corporation and its shareholders. *In re Lukens Inc. Shareholders Litigation*, 757 A.2d 720, 731 (Del. Ch. 1999). Under this heightened standard of review, at least when deciding whether to enjoin a transaction because of a claimed failure of the directors to fulfill their fiduciary responsibilities, the Delaware courts perform a two-step evaluation: (1) determining the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decisions; and (2) examining the reasonableness of the directors' actions in light of the circumstances then existing. n1

Before *Unocal* and *Revlon*, courts evaluated board decisions under the more lenient business judgment rule, whereby the board's decision was presumed to be made on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company, as long as the board's decision was made for any *rational* reason. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The burden fell to the plaintiffs to prove that the directors were breaching their duties. This level of scrutiny came to be known as a "bare rationality" standard of review.

Under the *Unocal* and *Revlon* enhanced scrutiny tests, Delaware courts evaluate the objective *reasonableness* of a board's actions to determine whether the board has complied with their fundamental fiduciary duties. *In re Toys "R" Us, Inc. Shareholder Litigation*, 877 A.2d 975, 1000 (Del Ch. 2005). Under enhanced scrutiny, even if a decision is made by the board for a rational reason it also has to be objectively reasonable, or the burden falls on the directors to prove that their actions were entirely fair. This enhanced scrutiny addresses the concerns of the courts regarding directors' decisions to sell control in a company from public or other minority stockholders to an individual or controlling entity, since the minority stockholders face the potentially permanent loss of both the strength of their voting power and the value of the control premium. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994). Enhanced scrutiny ensures that the minority stockholders can rely on the fiduciary duties owed to them by the directors, absent specific protections offered to them during a change in control.

The Revlon Duties: What Are They?

In addition to requiring a heightened level of judicial scrutiny of transactions involving a corporate change of control, the *Revlon* Court imposed stringent requirements on the process by which directors consider and approve a change of control transaction. The Court held that when a company embarks on a transaction that will result in a change of control, the directors' duties switch from preserving the corporation and following the best long term strategy for growth, to the "maximization of the company's value at a sale for the stockholders' benefit." *Revlon* at 182. These fiduciary duties are commonly referred to as the "Revlon Duties." In essence, when the Revlon Duties apply, the obligation of the directors is "is to seek the best value reasonably available to the stockholders." *QVC*, 637 A.2d 34. The board is required to seek the highest current value available; it is not permitted to choose a transaction with the prospect for a higher future value, but with a lower current value over a transaction that can be achieved in the near term. *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997).

When does a Stock-for Stock Merger Transaction Constitute a Change of Control and thereby trigger the Revlon Requirements?

Arnold v. Society for Savings Bancorp, Inc., 650 A.2d 1270 (Del. 1994), arose out of a merger in which Savings Bancorp Incorporated, a publicly-held Delaware corporation, merged with and into Bank of Boston Corporation ("BoB"). Plaintiff, a shareholder of Bancorp, sought to enjoin the merger claiming, inter alia, that the directors of Bancorp, by voting in favor of the merger, had breached their Revlon Duties. The Court of Chancery held that the merger did not involve a change of control and thus the directors were not subject to Revlon Duties. The Delaware Supreme Court affirmed that decision, concluding that an enhanced scrutiny of the directors' conduct in approving the merger was inapplicable under the circumstances.

The Delaware Supreme Court held that directors are subject to Revlon Duties, i.e., "the obligation of acting reasonably to seek the transaction offering the best value reasonable available to the stockholders," *QVC* at 43, in three situations: "(1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company; (2) where, in response to a bidder's offer, a target abandons its long term strategy and seeks an alternative transaction involving a break-up of the company, or (3) when approval of a transaction results in a sale or change of control." *Arnold* at 1290, citing *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990), and *QVC* at 42-43, 47.

Noting that "there is no sale or change in control when control of both companies remains in a large, fluid, changeable and changing market," the Court concluded that the merger of BoB and Bancorp did not involve a change of

control. *Id.* The Court rejected plaintiff's argument that "there was a sale or change in control of Bancorp because its former stockholders are now relegated to a minority status in BoB, losing their opportunity to enjoy a control premium." The Court explained that as a continuing BoB stockholder, the plaintiff continued to have an opportunity to receive a control premium.

Lessons from *Arnold v. Society for Savings Bancorp*

The decision of the Delaware Supreme Court in *Arnold* has important consequences for mergers involving Delaware corporations:

- The Revlon Duties apply in a stock-for-stock merger if the transaction results in a change of control of one of the constituent Delaware corporations. If, as a result of the merger, a single person or entity or controlled group will effectively control the surviving corporation, the directors of the acquired company are subject to Revlon Duties in considering and approving the transaction.
- If, following a stock-for-stock merger, the stock of the surviving company would be owned by "a fluid aggregation of unaffiliated stockholders," then neither the Revlon Duties nor judicial enhanced scrutiny of the directors' actions is applicable.
- In contrast to a stock-for-stock merger, a merger in which the stockholders of a publicly-held Delaware corporation receive cash for their shares will always trigger Revlon Duties on the part of the directors of the acquired company because the transaction results in a clear and unambiguous change in control of the acquired company.

Additional Resources

For a more detailed description of the Revlon Duties, see 1-12 Corporate Governance: Law and Practice § 12.05 (LexisNexis Matthew Bender).

For a full discussion on the business judgment rule, see Liability of Corporate Officers and Directors, Chapter 2, "Business Judgment Rule" and *Delaware Corporation Law and Practice* § 15.03.

[Return to Text](#)

ⁿ¹ Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 *Del. J. Corp. L.* 769, 858 (2006).

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Kenneth R. Thompson II is Senior Vice President and Global Chief Legal Officer for LexisNexis, a division of Reed Elsevier Inc. His core areas of expertise are intellectual property, acquisitions and divestiture, anti-trust, and Internet security issues. Indeed, in line with his security focus, the Chief Security Officer now reports to Ken, overseeing the governance and protection of the vast quantities of information that LexisNexis gathers and stores. As a member of the LexisNexis Group Management Committee, Ken leads and advises at the highest levels of the company. He also remains the principal legal advisor to the LexisNexis Global Chief Executive Officer. His broad expertise makes him an authoritative and highly engaging public speaker on his area of expertise.

Michael G. Schwartz is a partner at Vorys, Sater, Seymour and Pease LLP, in the Cincinnati office, and is a member of the probate and tax practice group. He represents individuals and closely-held businesses in all facets of

estate and business planning. His estate planning experience ranges from simple to the most complex estate plans. Mr. Schwartz is a frequent speaker on advanced estate and business planning topics at professional education seminars, including the Southwest Ohio Tax Institute, the Advanced Estate Planning Institute and the Midsouth Estate Planning Conference.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



7 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Aquila and Sawyer on Contingent Value Rights

2009 Emerging Issues 4364

Frank Aquila and Melissa Sawyer on Contingent Value Rights -- Means to an End: Using CVRs to Bridge Valuation Gaps in Public Company M&A Deals

By Mr. Frank Aquila Esq. and Ms. Melissa Sawyer Esq.

September 28, 2009

SUMMARY: Setting a deal price is often the toughest issue in negotiating M&A deals. When the gap cannot be bridged, innovative dealmakers use the flexibility of contingent value rights ("CVRs"). CVRs are derivative securities or contract rights that pay holders upon the occurrence of specified contingencies. They are being more widely used in M&A deals.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Setting a deal price is often the toughest issue in any negotiation, sometimes it is the only issue. In far too many deals, that gap cannot be bridged. Innovative dealmakers have long recognized that contingent value rights ("CVRs ") could be the perfect - albeit highly structured - solution. CVRs are derivative securities or contract rights that pay holders upon the occurrence of specified contingencies. While CVRs have been used in pharmaceutical and biotech M&A deals, they are not used widely in M&A deals. That could be changing because CVRs are an extraordinarily flexible tool that can be structured in an infinite variety of ways to suit the facts and circumstances of a particular transaction.

Although the financial, tax, legal and other aspects of CVRs can add complexity to a deal, those issues are far from insurmountable. This article suggests that CVRs should become a regular component of an M&A lawyer's arsenal and highlights certain technical considerations associated with using CVRs. First, this article describes a number of potential ways in which CVRs can be used in M&A deals. Second, this article describes certain of the key characteristics of CVRs that factor into their design.

Uses of CVRs

Typically in M&A deals, CVRs fall into two broad categories: (1) performance driven CVRs and (2) event driven CVRs. A third category, financing-related CVRs, is not widely used in M&A but may have many practical applications.

Performance-Driven CVRs

Performance driven CVRs are linked to the issuer's performance over a certain period of time. In an M&A deal, for

example, the buyer can issue performance driven CVRs to the target's stockholders, in addition to shares of buyer's common stock or cash. The CVRs could be structured in any of the following ways:

(1) *Hedging Instrument.* The CVRs would pay out cash or securities to the target's legacy stockholders if, on the maturity date, the buyer's stock is trading below an agreed level. CVRs with this design function as hedging instruments: They guarantee a minimum amount of consideration per target share after a prescribed period of time, even if the buyer's stock price drops after the deal is completed. These CVRs resemble put options by giving the target's stockholders down-side protection. n1 If they are separately traded instruments, these types of CVRs will have trading values that move inversely to the value of the underlying buyer stock (*i.e.*, as the buyer's stock price declines, the CVR would increase in value).

Why create a hedging instrument for target's stockholders, rather than letting the market generate its own hedging techniques? Among other reasons, the target's board may not feel comfortable agreeing to a transaction that requires stockholders to obtain their own hedges because that could lead to disparate outcomes for different types of stockholders. For example, sophisticated institutional stockholders are more likely than individual retail investors to have access to the knowledge and resources necessary to trade in derivatives. In addition, making the hedging instrument an official component of the deal consideration shifts the transaction costs associated with the instrument partially to the buyer and the buyer's legacy stockholders and partially away from the target's legacy stockholders.

CVRs that are designed like hedging instruments could be a particularly appealing option in an auction in which a potential buyer that is proposing to use stock consideration is competing with potential cash buyers. By including a CVR in its offer, the stock buyer may be able to make its offer more directly comparable to cash offers and to eliminate any concerns the target's board may have about volatility of the buyer's stock price. Such CVRs could also be used to deliver fixed value in a fixed exchange ratio deal in lieu of a floating exchange ratio/collar mechanism. Buyers should keep in mind, however, that issuing hedging CVRs can result in the buyer's stock price becoming depressed due to trading by arbitrageurs.

(2) *Earn-Out Instrument.* The CVRs would pay out cash or securities to the target's legacy stockholders if, on the maturity date, a business line, asset or other part of buyer that represents a legacy business of the target is performing at an agreed level. If the target believes that its future business plans are likely to generate greater value than is currently reflected in the target's stock price or the valuation multiple proposed by the buyer, the CVR would give the target's stockholders a means to participate in the future upside from the target's operations without sharing those benefits pro rata with the buyer's legacy stockholders. The CVRs simultaneously would allow the buyer to defer payments, giving the buyer time to realize synergies and manage downside risks before having to part with cash, securities or other assets. This type of CVR could help to bridge the gap between a conservative buyer's estimates of a target's future performance (*e.g.*, the "base case" view) and an optimistic target's expectations (*e.g.*, the "optimized case" view). This could be especially useful in transactions that require stockholder approval for both the buyer and the target because the CVRs can provide a means for balancing the need to pay the target's stockholder a price that is at a premium to its historical average stock price, while at the same time not causing the buyer to pay an EBITDA multiple that exceeds those paid in recent comparable transactions. n2

CVRs that are designed like earn-outs are complex. Among other reasons, they suffer from the same difficult issues that affect any kind of earn-out, including the fact that the parties must agree on all of the following potentially contentious characteristics of the CVR prior to announcing a deal: (1) which assets or business lines will form the basis for measuring the value of the CVR and what metrics and targets will be used to assess the performance of those businesses; (2) the maturity date; n3 (3) who will perform the relevant calculations and how those calculations will be tested and verified; (4) how changes in the buyer's accounting policies after the deal closes will impact the CVR's value; (5) whether and to what extent the buyer can engage in businesses that compete with the businesses underlying the CVR; (6) whether the buyer can sell or discontinue the businesses underlying the CVR; (7) whether buyer should be subject to any ongoing operational restrictions to preserve the value of the businesses underlying the CVR; (8) whether buyer should be required to make any commitments to provide financing (including making capital expenditures) to, or

to perform services on behalf of, the businesses underlying the CVR; and (9) to what extent value-drivers unrelated to the performance of the businesses underlying the CVR (such as the effect of an upturn in the economy generally or efficiencies generated by the buyer at the corporate parent level that have an ancillary benefit for the businesses underlying the CVR) should be "read out" of the measurement of the performance of the businesses underlying the CVR. The market value of earn-out CVRs will depend on the market's expectations regarding the future performance of the relevant businesses.

A further potential use of earn-out CVRs is as a form of equity compensation for management/employees of the target that will be employed by the buyer post-closing. In this context, the CVRs would be granted not to the target's public stockholders, but just to the target's employees who will continue to work for the buyer post-closing. This structure may be particularly useful for acquisitions of businesses like financial advisory businesses, where the retention of human capital is vital to the future success of the combined company, or in leveraged buy-outs as a means to structure deferred compensation for the management participants. n4

Like tracking stock, n5 CVRs that are designed as earn-out instruments also raise issues concerning the need for separate financial reporting at the level of the business underlying the CVR. The SEC has stated that an issuer of tracking stock must include financial statements about the tracking stock in its Exchange Act reports. Many issuers provide separate financial disclosures for the benefit of CVR holders. n6

(3) *Post-Closing Adjustment Instruments.* The CVRs would pay out if certain financial metrics of the target exceed the estimated metrics incorporated into the buyer's initial offer price. That is, the CVRs could function like a post-closing working capital, book value or net assets adjustment of the type more traditionally used in private company M&A deals. This could be especially desirable in a deal in which the buyer is otherwise paying cash or using a floating exchange ratio to deliver a fixed value for the target at the closing. For example, if the target is in an industry (such as reinsurance) in which its stock price rises and falls largely in a direct relationship with the target's book value, the buyer could agree to pay the target \$X per share based on the target's book value at the end of the quarter preceding the signing date. If the target's book value at the closing is greater than \$X, the CVR would pay out the excess of the actual closing book value over \$X. Using the CVR in this manner would give the buyer time after the closing date to close the target's books and calculate the target's actual book value on the closing date. Note, however, that the simplest version of this CVR would only provide a "one-way" adjustment - that is, absent an escrow arrangement, the buyer would still have to take the risk that the post-closing adjustment turns out to be a negative number. n7

Event-Driven CVRs.

Event driven CVRs are, as the name suggests, linked to the occurrence of uncertain events. In M&A deals, they can be used to provide buyer with "insurance" against the occurrence of contingent liabilities, and/or to provide the target's legacy stockholders with additional value if specified contingent liabilities are not realized. The following are examples of events that could form the basis for structuring event-driven CVRs: (1) settlement/final disposition of lawsuit; n8 (2) final resolution of a regulatory investigation or achievement of regulatory milestones; (3) final resolution of financial restatement; (4) results of a drug trial or similar type of value-driving event; n9 (5) the divestiture of specified assets and (6) escrow release from an indemnification or other escrow account. Event-driven CVRs have been widely used by pharmaceutical companies and biotech companies that are accustomed to structuring milestone payments as part of research collaborations with the Food and Drug Administration as an independent, third party arbiter of whether milestones have been achieved.

The difference between performance-driven CVRs and event-driven CVRs is not always a bright line. Indeed, some transactions employ CVRs that include elements of both. n10 These categorizations are useful in that they provide a rubric for discussion, but in practice the names do not matter so long as the contractual provisions that define the CVRs are clear and enforceable.

Transaction Financing CVRs.

CVRs may facilitate the buyer's transaction financing if they are issued to financing sources to supplement debt financing. The CVR pay-outs would be linked to distributions on the buyer's common stock - *i.e.*, the CVRs would pay-out if the buyer's stock traded above a particular level post-closing. Unlike the performance-driven CVRs described above, however, the CVRs would not be issued to all of the target's stockholders. The most likely application of these CVRs would be in a leveraged buy-out in which the target's stockholders are receiving cash. The buyer would cause private equity funds to subscribe to the CVRs in exchange for providing committed financing for the cash consideration. The principal benefit of these CVRs would be that they would allow the buyer to pay a higher cash price to the target's stockholders while sharing the risk with financing providers. Those financing providers, in turn, may have a greater appetite to accept risk in exchange for a greater potential return that would otherwise be available through a term loan, and may have more flexibility to diversify their portfolios across multiple investments. What is the advantage of using CVRs in this context rather than making a private placement of preferred stock? Depending on how they are structured, these CVRs may just be contract rights (not securities) and therefore the buyer and its financing sources may have more flexibility to structure them in a manner that satisfies accounting, tax and other requirements of the financing sources. The utility of these instruments in any particular transaction would obviously need to be carefully vetted.

Designing CVRs: Characteristics and Considerations

The characteristics, terms and conditions of a CVR may be set forth in disclosure documents or in an agreement with a trustee who acts on behalf of the CVR holders (the latter will certainly be the case if the CVRs are issued pursuant to an indenture agreement that is qualified under the Trust Indenture Act).¹¹ Covenants in the governing CVR agreement may impose restrictions on the activities of the issuer and/or give the trustee authority to monitor the issuer's activities.

Obviously the design of any CVR needs to accord with its underlying purpose, as described in Part I above, and with the buyer's financial needs. For example, will the CVRs be settled in cash, stock or other securities? A variety of different factors are relevant to this decision, including the buyer's access to cash, the dilutive impact of stock-settled CVRs and the impact on the issuer's P&L. A CVR's design also needs to take into account various characteristics that are not strictly economic. An illustrative description of certain of these issues is set forth below, but this article does not purport to address how each of these characteristics would play out in any particular circumstance. On these matters, a buyer should work closely with its legal counsel and financial advisor to assess the costs and benefits of these, and other, design elements of CVRs.

CVR Registration/Qualification Requirements.

Whether a CVR is required to be registered under the Securities Act of 1933, as amended (the "Securities Act") depends on whether the CVR is a "security" or just a "contractual right". The Securities and Exchange Commission ("SEC") employs a five-pronged test to determine whether CVRs issued as merger consideration to selling stockholders is a security that must be registered under the Securities Act.¹² A CVR issued in a merger is not required to be registered if it meets the following criteria:

1. The CVR is an integral part of the consideration for the proposed merger;
2. The CVR does not have rights common to stockholders or represent an ownership interest in the buyer (*e.g.*, the CVR does not have rights to vote or receive dividends);¹³
3. The CVR does not bear a stated rate of interest;
4. The CVR is non-transferable and non-assignable, except by operation of law; and
5. The CVR is not represented by any form of certificate or instrument.

In some situations where the CVRs will be stock-settled, buyers "split the baby": they register the shares

underlying the CVRs on a Form S-4 registration statement at the time of the business combination transaction (together with the stock consideration paid in the transaction). They do not, however, register either (1) the CVRs themselves at the time of the transaction or (2) the shares underlying the CVRs at the time of their actual issuance pursuant to the CVRs. Since the shares underlying the CVRs are not registered at the time of issuance, the recipients do not receive a current prospectus at the time they settle the CVRs. The theory of this approach is that (1) the CVRs are a contractual right, not a security, and therefore are not required to be registered; and (2) the investment decision with respect to the shares underlying the CVRs is made at the time of the initial transaction and the subsequent issuance of shares pursuant to the CVRs does not involve a new investment decision. n14

In addition to registration requirements under the Securities Act, issuers of CVRs must also consider whether registration is required under the Securities Exchange Act of 1934, as amended (the "Exchange Act") or whether qualification of an indenture is required under the Trust Indenture Act of 1939, as amended (the "Trust Indenture Act").

Section 12(g) of the Exchange Act requires registration of "equity securities". If an issuer concludes that a CVR is not a security for purposes of the Securities Act, the issuer should also be able to conclude that it is not an "equity security" for purposes of the Exchange Act. Difficult questions, however, may arise if the issuer concludes the CVR is a security but has characteristics more akin to debt than equity. n15

If the issuer determines the CVRs are debt securities, the issuer should also consider what action, if any, the issuer is required to take under the Trust Indenture Act with respect to qualifying an indenture related to the CVRs. Under Section 304(a)(1) of the Trust Indenture Act, qualification is only required for (A) "notes, bonds, debentures or evidence of indebtedness, whether or not secured, or (B) a certificate of interest or participation in any such note, bond, debenture or evidence of indebtedness, or (C) a temporary certificate for, or guarantee of, any such note, bond, debenture, evidence of indebtedness, or certificate." Where the CVRs are not represented by certificates, bear no stated interest, and do not constitute a note, bond, debenture, or evidence of indebtedness as such terms are generally understood, Trust Indenture Act qualification may not be required. n16

Even if registration of a CVR is not required by reason of an exemption or otherwise, a buyer should consider whether registration of the instrument would be desirable for valuation or other reasons. n17 Registering CVRs may be the first step to having them listed and becoming freely tradable. Freely tradable CVRs are more liquid, and that liquidity gives holders an opportunity to capture value immediately and may make the CVR a more attractive form of consideration in a public company merger. Certainly if the CVRs are being issued as a hedging instrument, it will be necessary that they trade freely. Recipients of CVRs may also ascribe greater value to registered CVRs because the holders may then obtain the benefits of disclosures and protections under the securities laws. Finally, recipients may ascribe value to the additional risk management and arbitrage opportunities available in connection with tradable CVRs. Especially where the buyer is already planning to file a Form S-4 registration statement with respect to the common stock it proposes to issue in the transaction, the benefits of registering and listing the CVRs may out-weigh the costs. On the other hand, there may be no reason to register a CVR that is cash-settled or that is being issued in a private placement as part of the financing arrangements for a cash acquisition.

Listing Requirements.

Each of the major stock exchanges has issued listing standards applicable to CVRs.

New York Stock Exchange. The CVRs and the issuer must satisfy the following requirements n18:

- The issuer must have assets in excess of \$100 million and must satisfy the requirements of Paragraph 102.01 of the NYSE Listed Company Manual;
- There must be at least one million CVRs outstanding;
- There must be at least 400 holders of CVRs;
- The CVRs must have an aggregate market value of at least \$4 million;
- The CVRs must have a minimum life of one year; and

- The CVRs may be delisted if their aggregate market value falls below \$1 million.

NYSE ARCA. The CVRs and the issuer must satisfy the following requirements:

- There must be at least 600,000 publicly held CVRs with an aggregate market value of at least \$18 million;
- There must be at least 1,200 public beneficial holders of the CVRs;
- The issuer must have total assets of at least \$100 million;
- The issuer must (1) have a net worth of at least \$4 million and (2) have pre-tax income from continuing operations of at least \$1 million in the last fiscal year or two of the last three fiscal years; and
- The CVRs must have a maturity of at least one year.

NASDAQ. The CVRs and the issuer must satisfy the following requirements:

- The issuer must have assets in excess of \$100 million and stockholders' equity of at least \$10 million. In case an issuer is unable to satisfy the income criteria set forth in the Rule 5400 or 5700 Series, NASDAQ generally will require the issuer to have the following: (1) assets in excess of \$200 million and stockholders' equity of at least \$10 million; or (2) assets in excess of \$100 million and stockholders' equity of at least \$20 million;
- There must be at least 400 holders of the CVRs;
- There must be a minimum public distribution of 1 million CVRs; and
- The aggregate market value/principal amount of the CVRs must be at least \$4 million.

Disclosure Requirements.

If CVRs are listed, the issuer will be subject to Exchange Act reporting requirements. This may not be an unwieldy burden if the issuer already has another security listed on an exchange or registered under the Exchange Act.

When a CVR is an earn-out CVR whose value varies based on the performance of a division or business unit of the issuer, the issuer should consider whether it is required to satisfy any information reporting requirements at the level of the division or business unit. Such requirements could arise under the Exchange Act or pursuant to the agreement pursuant to which the CVRs are administered.

"Preferred Stock"-Like Rights

The design of a CVR should take into account whether the CVR will carry any rights and preferences akin to those typically provided to holders of preferred stock: *e.g.*, dividends, class voting/veto rights and redemption rights (optional v. mandatory). Decisions on these matters can affect the determination of whether the CVRs are "securities" or "equity securities" for Securities Act and Exchange Act purposes, among other matters.

Corporate Approvals

The nature of the corporate approvals required to issue CVRs will depend on whether the CVRs are equity securities, debt securities or contract rights. If the CVRs are registered and/or listed, the issuer will likely be required to obtain one or more legal opinions as the due authorization and issuance of the CVRs. Care should be taken to ensure all necessary stockholder and board approvals are obtained and that the issuer complies with all other actions necessary under state law and the buyer's organizational documents, as well as under any material contracts (such as credit agreements or indentures).

Fiduciary Duties

If a buyer issues CVRs that are securities, the buyer's board will have to consider how to balance the rights of CVR holders against the rights of holders of its common stock. For example, when the board makes decisions about how to allocate capital, new business opportunities and other corporate resources between different business units, the board should consider whether the existence of an earn-out CVR that is linked to the performance of a particular business unit will have any impact on the board's fiduciary obligations. State corporation law offers some guidance on how a board

should balance the interests of one group of security holders as compared to holders of other classes of the corporation's securities. n19 If this issue can be anticipated, it can be addressed to a limited extent in the documentation defining the rights and preferences of the CVRs.

Fraudulent Conveyance and Other Insolvency Issues

A CVR issuer should consider the treatment of CVRs under applicable fraudulent conveyance and bankruptcy laws. Whether a CVR holder will be treated as a creditor (and the seniority thereof) or an equity-holder will depend, in part, on whether the CVR is viewed as an equity security, a debt security or a contractual right.

Enforcement Issues

A target whose stockholders will receive CVRs in the transaction must consider how its stockholders will be able to enforce the terms of the CVRs. If the CVRs are issued pursuant to a trust agreement, the trust agreement will likely give the trustee certain powers to enforce the terms of the trust agreement against the issuer. If the CVRs are not securities, however, the parties need to address whether the CVR-holders will have third party beneficiary rights under the merger agreement or other agreement pursuant to which the CVRs were granted. With respect to earn-out CVRs in particular, the parties need to address to what extent the CVR holders would have standing to bring claims that the buyer devoted inadequate resources to the underlying business unit and any fiduciary duty claims. In this respect, it may be wise for the buyer to consult with litigation counsel to assess to what extent CVR-holders may be able to form a separate class of plaintiffs and/or piggy-back on litigation brought by other groups of investors.

Tax Impact

A comprehensive analysis of the tax aspects of CVRs is beyond the scope of this article and an issuer should always seek advice from a tax specialist prior to creating a CVR. In fact, the classification of CVRs remains an open question under current Internal Revenue Service ("IRS") regulations. In Revenue Ruling 88-31, the IRS did address the issue in the context of a particular set of facts. In that transaction, the CVRs were hedging CVRs that were separately tradable but distributed at the same time as common stock. The IRS determined that the CVR diminished a stockholder's risk of loss from a decline in value, so the CVR constituted an option within the meaning of *Section 1092(d)(3)(B)(i)(I) of the Internal Revenue Code of 1986*, as amended. Accordingly, the IRS stated that "any gain or loss recognized by the taxpayer on the sale . . . or on the exercise of the Right, is a short-term or long-term capital gain or loss, depending on the holding period" and the issuer of the CVR recognizes no gain or loss on the CVR issuance, on the repurchase of the CVR or on the lapse of the CVR. For federal income tax purposes, distribution of a CVR is usually treated as the receipt of a dividend distribution from the issuer of the CVR in an amount equal to the fair market value of the CVR on the date of distribution. If the CVR is traded publicly as a separate instrument, the fair market value may not be difficult to ascertain. A buyer should consider carefully (1) what disclosure, if any, the buyer will provide in its SEC filings regarding the tax treatment of the CVRs n20 and (2) whether the issuance of CVRs will have any impact on the tax treatment of the overall transaction (*e.g.*, if the transaction is intended to qualify as a tax free reorganization).

Accounting Impact

The issuer of a CVR should consult with its accountants regarding the accounting treatment of the CVR. Under Financial Accounting Statement 141R, contingent consideration used in M&A transactions (such as CVRs) are required to be recorded at fair value as liabilities on the closing date of the transaction. It is no longer possible to wait to record the liability until a later date when the contingency is resolved. The fair value of cash-settled CVRs would be subject to adjustment in each accounting period until the CVR matures. Equity-settled CVRs, in contrast, would not be subject to further adjustment.

Composition of Stockholder Base and Stockholder Communications

Ultimately, the appeal of CVRs as merger consideration may depend on the composition of the target's stockholder base. Institutional holders may be more amenable to receiving a CVR than retail holders. n21 A buyer should consult with its proxy solicitor as to how a CVR would be received by its stockholder base, taking into account historic arbitrage activity and the availability of viable alternatives. If the parties to an M&A deal decide to proceed with a CVR, they should take care that their investor presentations, disclosure documents and other stockholder communications describe the CVRs accurately and in plain English.

III. Conclusion

There is a lot of untapped potential for the use of CVRs in M&A deals outside of the biotech and pharmaceutical industries. For the most part, CVRs could be especially useful in connection with acquisitions of companies that are distressed due to liquidity issues but that otherwise believe they have profit potential. As suggested, CVRs can be complex and do present numerous thorny issues that the parties and their advisors will need to address at the outset of the deal. This is a great opportunity for financial advisors and legal counsel to work together to structure "pareto optimal" solutions to valuation gaps in public company deals. With a little creativity, CVRs can be invaluable tools in bridging the value gap in M&A deals.

Additional Resources

For more on mergers and acquisitions, see the M&A Practice Guide (LexisNexis) and Corporate Acquisitions and Mergers (Matthew Bender).

[Return to Text](#)

n1 For a good description of how a financial advisor may evaluate the pros and cons of using CVRs as hedging instruments in a particular transaction, *see* Goldman, Sachs & Co.'s Presentation to the Special Committee of Genentech Inc. in Exhibit (c)(2) to Genentech Inc.'s Schedule 14D-9/A filed on March 12, 2009. The presentation also cites a number of precedent merger transactions that used CVRs, including Wesfarmers-Coles (2007), Publicis-Saatchi & Saatchi (2000), BNP-Paribas (1999), Suez-Lyonnaise-Generale de Belgique (1998), Viacom-Blockbuster (1994) (VCRs), and Viacom-Paramount (1994). Other examples of transactions that used CVRs as hedging instruments include ViroLogic-Aclara (2004); Mannkind-Pfizer (2009); and Dow Chemical-Marion Laboratories (1991).

n2 Examples of transactions that used earn-out CVRs include: Fresenius SE-App Pharmaceuticals (2008); Onstream Media-Narrowstep (2008); and Minnesota Mining and Manufacturing/Cardiovascular Devices (1988).

n3 On average, it appears the maturity dates for CVRs used in M&A transactions are between 1 and 3 years. Under the New York Stock Exchange ("NYSE") listing rules, listed CVRs must have a minimum life of at least one year.

n4 Issuers should consider the applicability of "going private" transaction rules and the accounting and tax impacts of using CVRs as equity compensation. In addition, even if the transaction is using CVRs that do not have a compensatory purpose, a buyer will need to determine to what extent roll-overs of equity awards will take into account the CVRs that are being issued to the target's legacy stockholders.

n5 Tracking stock is a separate class of stock of an issuer that "tracks" the results of a particular business line or division of the issuer. For example, Sprint once issued tracking stock that tracked the results of the Sprint PCS wireless division. The issuer retains control over the division and the holders of the tracking stock have limited voting rights. Tracking stock once was viewed as an alternative to a spin-off. After an initial surge of issuances of tracking stocks in the late 1980s and 1990s, however, tracking stocks are no longer widely used today. Since tracking stocks are analogous to earn-out CVRs in some respects, practitioners should review the literature regarding tracking stocks prior to structuring earn-out CVRs. That being said, when CVRs are being used as a form of merger consideration, they are perhaps more properly viewed as deferred payments rather than just merely "different slices of the same pie" (the latter being an oft-repeated criticism of tracking stock that was issued outside of the M&A context).

n6 *See, e.g.*, Fresenius Kabi Pharmaceuticals Holding, Inc. Annual Report on Form 10-K for the year ended December 31, 2008, at 33 (issuer presents calculation of adjusted EBITDA under the CVR indenture for the fiscal year).

n7 It does not appear that the SEC has taken the view that the uncertainty/contingencies associated with the payments to be made pursuant to a CVR necessarily impact a shareholders' ability to grant a fully-informed proxy, so long as the issuer provides adequate disclosure regarding the contingencies, a copy of the CVR agreement, risk factors relating to the CVRs and any estimates made on the value of the CVRs as part of the total merger consideration. *See* Southpeak Interactive Corp., SEC Comment Letter Response (May 16, 2008); Clinical Data, Inc., SEC Comment Letter Response (June 15, 2009).

n8 Historically, CVRs have been widely used outside of the M&A context in connection with litigation settlements in class action litigations. *See, e.g.*, Information Resources, Inc. Litigation Contingent Payment Rights Trust, Form 8-K, Exhibit 99.1 (May 16, 2006).

n9 Examples of transactions that used CVRs based on product regulatory approvals include: Ligand Pharmaceuticals/Pharmacopeia (2008); Fresenius SE/APP Pharmaceuticals, Inc. (2008); OSI Pharmaceuticals/Cell Pathways (2003); Antigenics/Aronex Pharmaceuticals (2001); Elan/Liposome (2000); and Ligand Pharmaceuticals/Seragen.

n10 *See, e.g.*, Essex Communications Corp., SEC No-Action Letter (June 28, 1988) (example of cash-settled CVRs used for a post-closing adjustment and an indemnification escrow).

n11 For an example of a CVR agreement with a trustee, *see* Monogram Biosciences, Inc.'s Form 8-K (Dec. 10, 2004) (Exhibit 10.3 is a Contingent Value Rights Agreement, dated as of December 10, 2004, by Virologic, Inc. to U.S. Bank National Association as Trustee). In that transaction, the CVRs were registered securities.

n12 *See* Minnesota Mining and Manufacturing Co., SEC No-Action Letter (Oct. 13, 1988). The five-prong test appears to be derived, in part, from the traditional *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1945), analysis of whether a right is an "investment contract". *See, e.g.*, Northwestern Mutual Life Insurance Co., SEC No-Action Letter (March 3, 1983). Contingent value rights are not unique to transactions for U.S. issuers. *See, e.g.*, Centrica/EDF Group deal (May 2009); *see also* Contingent Value Rights: A New Takeover Currency? Michael Shaw, Gavin Davies, Mark Bardell and Kelly Bassett (April 2009) for a list of recent UK takeovers employing CVRs. The parties in any non-U.S. transaction need to consider to what extent the issuance of CVRs in an otherwise all-cash deal could subject the issuer to U.S. securities laws and reporting requirements.

n13 Certain SEC no-action letters also cite as relevant the fact that a CVR would not pay out to the holders depending on the operating results of the company. On its face, this would appear to imply that all earn-out CVRs are required to be registered. However, in Genentech Clinic Partners III, SEC No-Action Letter (March 23, 1989), the SEC appeared to accept that where the "earn-out" is based on the operating results of a division or a subsidiary, but not on the performance of the issuer as a whole, the CVRs do not represent an equity or ownership interest in the issuer itself and are not required to be registered (all other prongs of the test being satisfied).

n14 Minnesota Mining and Manufacturing Co., SEC No-Action Letter (Oct. 13, 1988). In another "split the baby" permutation, in the Monogram Biosciences, Inc./ViroLogic deal (2004), ViroLogic registered the CVRs on Form S-4 and the Form S-4 described the manner in which the parties addressed the need for subsequent registration of shares issues pursuant to the CVRs as follows: "If ViroLogic elects to make any portion of a payment to holders of CVRs through the issuance of shares of ViroLogic common stock then, as a condition precedent, such shares must, among other things, be issued either in a transaction that is exempt from registration under the Securities Act through satisfaction of the requirements of Section 3(a)(9) of the Securities Act, or pursuant to an effective registration statement under the Securities Act. If these conditions precedent cannot be satisfied then ViroLogic must make the entire amount of any payment due under the CVRs in cash." Monogram Biosciences, Inc. Form S-4, at 122 (Nov. 4, 2004). ViroLogic also agreed to use commercially reasonable efforts to cause the CVRs to be approved for listing on an exchange. The ViroLogic CVRs were stated to be unsecured obligations of ViroLogic that ranked equally with all other unsecured obligations of ViroLogic.

n15 In Pension Benefit Guaranty Corp., SEC No-Action Letter (May 25, 1993), the SEC agreed to rely on counsel's opinion that the CVRs at issue were not "equity securities" within the meaning of the Exchange Act (and, hence, were not required to be registered under Section 12(g) of the Exchange Act) where the CVRs were "contingent obligations of the PBGC to pay specified amounts according to a formula" based on the performance of an entity's common stock such that the CVRs appeared to "combine elements of debt and equity and [were] hybrid instruments." No-action requests also frequently assert that no public policy would be served by requiring registration of CVRs under the Exchange Act where the CVRs are not transferable or assignable except by operation of law and where the issuer is already subject to Exchange Act reporting requirements.

n16 See Essex Communications Corp., SEC No-Action Letter (Jan. 12, 1988) (registration/qualification of "deferred cash consideration right" not required). In contrast, see Green-Wood Assocs., SEC No-Action Letter (Sept. 12, 1990) (staff determined CVRs issued in exchange for bonds appeared to be "evidence of indebtedness" such that Securities Act registration and Trust Indenture Act qualification may be required).

n17 In the transactions referenced in footnote 1, all of the CVRs were registered and all but one were listed.

n18 See SEC Order Approving Proposed Rule Change Relating to the Adoption of Listing Standards and a Membership Circular for Contingent Value Rights, Release No. 34[#8209]28072 (May 30, 1990).

n19 See, e.g., *Solomon v. Armstrong*, 747 A.2d 1098 (Del. Ch. 1999) and *In re General Motors Class H Stockholder Litigation*, 734 A.2d 611 (Del. Ch. 1999).

n20 See, e.g., ViroLogic, Inc. Registration Statement on Form S-4, at 96 (Nov. 4, 2004) (noting that contingent value rights might be treated as debt instruments or in some other manner based on future regulations, court decisions or revenue rulings).

n21 As of July 2009, Risk Metrics Group did not disclose any policy on CVRs on its website.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ABOUT THE AUTHOR(S):

Frank Aquila is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. His practice focuses on mergers, acquisitions, strategic alliance and corporate governance matters for large multinational corporations. Mr. Aquila has been lead outside counsel to companies such as Anheuser-Busch InBev, Amgen, British Airways and

Diageo with respect to many of their most significant transactions. Mr. Aquila received a Burton Award for Legal Achievement in 2005 and was named a "Dealmaker of the Year" by the American Lawyer in 2009. He received his A.B. degree from Columbia University and his J.D. degree from Brooklyn Law School.

Melissa Sawyer is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. Her practice focuses on a variety of corporate, mergers, acquisitions, strategic alliances and private equity matters, both in the U.S. and internationally. Ms. Sawyer was featured in "The Facebook of Wall Street's Future" (New York Times, October 3, 2007) as one of Wall Street's "next generation of deal makers." She received her B.A. degree from Washington & Lee University and her J.D. degree from the University of Virginia Law School.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



8 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Aquila and Feldstein on Distressed Acquisitions

2009 Emerging Issues 4296

Frank Aquila & Hydee Feldstein on Distressed Acquisitions -- Brave New World or Variation on a Familiar Theme?

By Mr. Frank Aquila Esq. and Ms. Hydee Feldstein Esq.

September 16, 2009

SUMMARY: Distressed M&A activity continues to be one of the most active segments of the deal market despite signs of improvement in the economy and recovery in the credit markets. Discussions of rights plans and "go shops" are being replaced by fraudulent conveyance risk, 363 sales and plans of reorganization and the "failing company" defense.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Distressed M&A activity continues to be one of the most active segments of the deal market even as the economy begins to improve and the credit markets continue to recover. Increasingly, distressed sales head to bankruptcy court for approval and the bankruptcy sale process, in which a bankruptcy court approves a sale "free and clear" of claims, liens and interests, if not squarely in the mainstream of distressed M&A activity, has at least become a more visible and effective tool for consummating the sale of a business as a going concern. n1 A sale under *section 363 of the Bankruptcy Code* n2 can preserve concern value for a company that lacks the liquidity to sustain itself through a reorganization plan. Moreover, in the current litigious environment where acquisitions consummated outside of bankruptcy are aggressively attacked on fraudulent transfer or other grounds, n3 the ability and willingness of bankruptcy courts to approve emergency sales outside of a plan context are often presented as the only viable option to the liquidation of a business.

Usually, the primary motivation for dealing with a financially troubled seller is the opportunity for a bargain and basic principles of contract law include the right of each party to a contract to enjoy the benefit of the bargain. Obtaining that benefit from a solvent seller poses little risk that the sale will be successfully challenged or set aside as a fraudulent transfer. n4 The buyer typically seeks to preserve the benefit of its bargain by obtaining valuable representations, warranties and covenants regarding the nature of the business purchased that usually survive the closing of the transaction. When the purchase is financially troubled, however, the risk that the transaction will come under subsequent scrutiny and attack as a fraudulent transfer or otherwise increases dramatically, while the utility and value of commercially customary representations decline materially.

Conventional wisdom has been that consummating the acquisition after a formal bankruptcy proceeding has been initiated, either as a part of a proposed plan of reorganization or as a sale approved under *Section 363 of the United States Bankruptcy Code* (the "Code"), effectively immunizes the transaction from subsequent attack as a fraudulent transfer. It is a truism that the power of the bankruptcy court to order that a sale "free and clear" of the claims, liens and

interests in the assets of the seller or the business sold provides the best traditional protection from known or hidden liabilities following an acquisition. While a bankruptcy court order provides the best title obtainable to the buyer of a distressed business, the ever larger sales compressed into ever shorter time frames in the current environment, whether or not approved by a bankruptcy court, have resulted in a litigation littered landscape among the constituencies in the seller's bankruptcy.

Financially troubled companies are typically unwilling sellers, seeking the immediate receipt of cash, certainty of closing and the release of the seller from as many of the liabilities of the business sold as possible. These factors are often more critical drivers of a distressed sale than obtaining the highest possible purchase price. From the perspective of the seller who is not yet in bankruptcy (and, to a lesser extent, the buyer), a bankruptcy filing traditionally has had substantial drawbacks. First, the filing of a bankruptcy can have potentially far-reaching consequences for the seller and its affiliates. The adverse publicity, supplier and customer jitters, disclosure of proprietary information, management distraction and business disruption from the filing of a bankruptcy for one entity is not readily containable and can deal the blow that may result in additional filings by related entities. In many instances, a filing will trigger defaults under an affiliate's loan agreements, debentures, guaranties or other contractual obligations. Second, there are substantial costs, delays and a measurable loss of control over the proposed sale inherent in a bankruptcy proceeding since nearly every material business transaction is subject to public scrutiny by creditors and other parties in interest and requires the approval of the bankruptcy court. A bankruptcy results in new constituencies (usually one or more committees of creditors or equity holders) who become involved in the debtor's affairs and who employ professionals (lawyers, accountants, investment bankers and consultants), all of whom are usually entitled to payment at the expense of the target. Thus, a bankruptcy filing can and often does result in substantial fees and expenses (in a large case, in the tens or even hundreds of millions of dollars) payable by the seller.

Moreover, the loss of control that results from a filing also is undesirable from the perspective of the buyer. A filing raises the possibility that creditors will attempt to renegotiate the transaction and the certainty that the acquisition will be subject to competitive bidding procedures. While even out of court transactions inevitably go through a process in the current environment and overbid procedures provide some protection for the prospective purchaser in a bankruptcy, there is also the real risk that a bankruptcy purchase may go to another bidder or may cost more than the acquirer would have had to pay for the same business in an out-of-court transaction. Moreover, creditor constituencies have grown increasingly willing to engage in lengthy multi-faceted litigation in the effort to require the buyer to pay a higher price for the acquisition than agreed, by objecting to and appealing orders regarding the sales process itself, by collaterally attacking the sale after the fact or by proposing or supporting an alternative transaction or stand-alone reorganization.

If the purchaser's goal is to achieve finality in the sale, the identity and objectives of the other parties that may be at the table or may be able to reopen the negotiation in the future could be critical. One effect of the changed economic climate is that the external financing available for a leveraged acquisition is more limited and where available, is at lower multiples and higher prices than in recent years. Thus, the distressed acquisition must be structured more carefully in order to be acceptable to proposed lenders and the availability of financing cannot be assumed. In addition, if there are critical assets, such as leases or licenses, which require the consent of a third party to their transfer, these relationships may affect the structure of the transaction whether in or outside of a bankruptcy. Finally, the financial condition of the seller and the buyer following the closing of the transaction will be of critical importance in determining the extent to which a bankruptcy filing is likely to result from the acquisition and the likelihood that there will be a renegotiation or litigation.

As with any acquisition, the purchase of a financially troubled business will consist of some variation on three familiar themes: (1) the acquisition of assets; (2) the acquisition of the legal entity owning those assets; or (3) the acquisition of "control" over the legal entity owning the assets. The purchase of claims against an insolvent entity is merely one twist on the familiar theme of acquiring control. The leveraged acquisition, where the assets of the target serve to secure indebtedness incurred to pay the acquisition price, comes under scrutiny most often as a constructive fraudulent transfer.

Fraudulent Transfers

While many distressed deals will be done out of court, there are a variety of laws and theories under which shareholders or creditors may sue the acquirer of, or of assets from, a financially troubled entity, the most familiar of which are the fraudulent transfer laws. n11 If the creditors of a seller are left unpaid or if the seller winds up in bankruptcy within the statutory period, the buyer may find itself back at the table litigating or renegotiating the price to settle the claims of these parties.

The essential premise of the fraudulent transfer laws is the same - the creditors of an insolvent entity have the right and the standing to challenge the entity's transfer of its assets (or the dilution of their interest by the incurrence of an obligation) for less than full and fair consideration. Since the creditors of an insolvent entity are left unpaid and any additional value would have been available for their benefit but for the transfer or incurrence, it is the creditors who are injured if the debtor makes a gift or a bad business bargain and the fraudulent transfer laws provide redress for that injury. n12

By definition, a sale is a "transfer" of the seller's interest and the premise of this article is that the seller is at least arguably insolvent. So that leaves the payment of "fair consideration" or "reasonably equivalent value" as the sole remaining defense, a determination that is always subject to 20/20 hindsight in the valuation of the assets transferred and affected by the perception of the bargain price that attracts the buyer in the first place. There is no structure that can insulate an out-of-court sale from a subsequent fraudulent transfer attack; there are, however, some steps that a buyer can take to mitigate the risk that such a claim will be successful if brought.

It is only the creditors of the seller or one who stands in the shoes of creditors, such as a bankruptcy trustee or debtor in possession, that have the standing to bring a fraudulent transfer claim. These parties traditionally had no seat at the table in the negotiation and consummation of the out-of-court purchase. The risk of fraudulent transfer claims is usually the single greatest risk in an out-of-court purchase from a financially troubled seller. A request for an opinion from seller's counsel on the issue is almost always unavailing, or an opinion, if obtained, is so guarded as to raise more risk than it obviates. The best a buyer can do is to be sure that the seller has conducted and carefully documented a robust sale process or to require a post-execution "go-shop." Some buyers diligence and document the payment in full of all creditors of the seller (a strategy of limited utility even if the acquisition is of substantially all the assets of the seller given that unknown, contingent and future liabilities often materialize). The acquirer on occasion (but rarely) has the luxury of obtaining representations and an indemnity from a solvent parent or the ability to hold back a substantial portion of the purchase price to satisfy indemnification obligations from an otherwise insolvent seller. Finally, a number of buyers take some comfort in the fairness and solvency opinions that have been developed and are often provided. While not dispositive, they can be helpful in subsequent litigation. n13

Out of Court Liabilities

If the out-of-court purchase is the purchase of the stock or other equity interests in the selling entity, the purchased entity obviously will continue to be liable for its debts and liabilities. The general rule, of course, is that the acquirer of assets (rather than stock or equity) will not be liable for the debts of the selling entity. n14 There are substantial exceptions to this rule, however, regarding the circumstances under which an acquirer will be held liable as the successor of the seller. The standard exceptions are as follows n15:

- Agreement -- the acquirer expressly or implicitly agrees to assume the liabilities of the seller. n16
- De Facto Merger -- the sale amounts to a consolidation or merger of the seller and its business with the buyer. n17
- Mere Continuation -- the acquirer is a "mere continuation" of the seller's existing business operation. n18
- Fraudulent Intent -- the transaction is entered into fraudulently for the purpose of escaping the seller's liabilities. n19

Some courts have broadened the traditional exceptions listed above, at least in the products liability area, to impose liability on the successor/acquirer for injuries caused by products manufactured and distributed by the predecessor/seller. While the expansion of the traditional doctrine has been expressly rejected by some courts, n20 the

products liability area has given rise to the imposition of liability in situations that do not fit the traditional successor liability doctrine, either under the so-called "continuity of enterprise" exception, or the "product line" exception which holds the successor/acquirer liable under certain circumstances for injuries caused by those of the seller's product lines which the acquirer continues to market. n21

Furthermore, the employees of a financially troubled business may have additional bases upon which to assert claims for wages, accrued vacation or other benefits that remain unpaid following an acquisition under state or federal law against the acquirer and there are notice requirements and other limitations on reductions in force under the "WARN" Act. n22 In addition, so-called "hot goods," e.g., those produced in violation of the wage and hour requirements of the Federal Labor Standards Act, may carry liabilities with them. n23

In addition to the risk that the transaction will be subject to a subsequent legal attack, an insolvent seller raises a variety of pragmatic and business concerns, particularly in an out-of-court context. Often, a troubled seller has, due to its financial difficulties, angered customers and suppliers alike, has obsolete inventory on hand or has a number of receivables that may be subject to offset or are uncollectible. An out-of-court purchase of assets also remains vulnerable to contingent or unliquidated liabilities that may not be readily ascertainable, such as environmental clean-up liabilities or so-called "hidden liens". n24 These may not be issues in a number of contexts but it is important to engage advisors and counsel with experience in distressed acquisitions to assist in evaluating whether, in a given transaction, the practical difficulties of effectuating a transfer without the "clean break" of a bankruptcy sale may be insurmountable.

The Bankruptcy Option

The principal benefit of a bankruptcy sale to the buyer derives from the court's order authorizing the sale to the buyer "free and clear" of claims, interests and liabilities, including the hidden lien, successor and products liability, employee liabilities and other statutory and common law liabilities inherent in the out of court purchase.

The principal detriment to the buyer of course is the distressed seller's inherent option with respect to the acquisition agreement negotiated out of court and the very real possibility that a distressed target will have a second or third bite at the apple when it files for bankruptcy after a deal is signed but before it is closed. While lock-ups, break-up fees and expense reimbursement provisions may be easier to obtain outside of bankruptcy than in bankruptcy, when a distressed target files for bankruptcy the value of these paper rights can disappear. If the distressed target files for bankruptcy the acquisition agreement is likely to be treated as an executory contract under Section 365 of the Code and the distressed target would be given the power to assume or reject the acquisition agreement. If the agreement is rejected, any damages payable to the buyer generally would be unsecured claims. In addition, any lock-up or unreasonable break-up fee could be used by creditors or others as an indication of unfair pricing and, upon filing, will be unenforceable. Therefore, when dealing with a distressed target outside of bankruptcy, it is important to recognize that an acquisition agreement is similar to an option, as the distressed target may decide not to perform the acquisition agreement in bankruptcy without significant adverse consequences.

There is no effective closure on the question of closing certainty when negotiating an out of court acquisition agreement with a distressed target that may file for bankruptcy before the actual filing. The recognition that the acquisition agreement is really like an option for the distressed target will have structural consequences for the buyer and its counsel in negotiating the deal. Buyers should consider whether they should be committed at all in advance of closing or filing if the distressed target effectively is not, the length of time of any purchase commitment, and the conditions to the commitment (including the effect of continued financial distress on the target business and its supply, vendor and other relationships). In appropriate circumstances, buyers also might consider writing an express option in exchange for a fair up-front cash payment by the seller for the value of the option - allowing the seller to establish a floor for the asset price and conduct a robust sales process while providing out of court.

The Failing Firm

The distressed nature of a seller may improve the likelihood of securing antitrust approval for certain transactions. Antitrust regulators are able to take into account the financial distress of one party in their analysis of a transaction under the failing company defense. The Supreme Court first recognized the failing firm defense in the *International Shoe* decisionⁿ²⁵ and further endorsed the defense in the *Citizen Publishing* decision.ⁿ²⁶ The failing firm defense is currently set out in Section 5.1 of the 1992 Merger Guidelines.ⁿ²⁷ Section 5.1 provides that an otherwise anti-competitive merger may be allowed to go forward if one of the parties to the merger can satisfy four requirements: (1) the allegedly failing company "would be unable to meet its financial obligations in the near future"; (2) the allegedly failing company "would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Code"; (3) the allegedly failing company has made "unsuccessful good faith efforts to elicit reasonable alternative offers of acquisition" that would raise fewer competitive concerns; and (4) "absent the acquisition, the assets of the failing firm would exit the relevant market." Although bankruptcy lawyers often cite to the exception as a standard additional benefit in bankruptcy, the technical requirements of the defense are strict and difficult to satisfy, so that the application of the defense remains quite rare. There is some uncertainty as to whether the failing company defense applies to the acquisition of a failing division or other part of a financially solvent company. The courts that have considered the validity of the failing division defense are divided on the issue.ⁿ²⁸ The failing division defense is set out in Section 5.2 of the 1992 Merger Guidelines. Section 5.2 of the 1992 Merger Guidelines provides that an otherwise anti-competitive acquisition of a corporate division may be allowed to proceed if (1) the division has a negative cash flow on an operating basis, (2) there is evidence that, absent the acquisition, the assets of the division would exit the relevant market in the near future, and (3) the owner of the failing division has made reasonable good faith efforts to sell the division, at any price above liquidation value, to an alternative purchaser that would raise less competitive concerns.

The Art of the Possible

Section 544 of the Code provides the predicate for a debtor in possession or a trustee in the seller's bankruptcy to challenge an acquisition as a fraudulent transfer or on other bases available to creditors under applicable state law, thus preserving for the seller itself, as debtor in possession, the ability to renegotiate the very deal it cut before filing a bankruptcy case.

In addition, a sale consummated within two years of seller's filing for bankruptcy may be a fraudulent transfer as a matter of federal law under section 548 of the Code. If the challenge under either section 544 or 548 proves successful, the acquirer could be required, under section 550 of the Code, (1) to return the assets or business acquired to the estate; or (2) to pay an amount equal to the "value" of what was sold and while that value is to be determined as of the date of the acquisition, the determination is by a bankruptcy court after the fact and often years after the closing.

Finally, the Code itself contains a number of provisions which facilitate the sale of a business. For example, as discussed below, the debtor may sell "free and clear" of third-party claims or interests and the debtor may assign leases, licenses and contracts, notwithstanding a provision in those agreements or under state law restricting their assignability.

Under these circumstances, irrespective of the seller's desire to avoid a bankruptcy, the buyer may well conclude that the assets or business are "untouchable" absent a very deep discount (which itself increases the fraudulent transfer risk) or judicial supervision and approval of the sale. At the end of the day, the deal often goes to the brave. While a more cautious acquirer can gain substantial benefit from a sale "free and clear" of all claims and interests under section 363(f) of the Code or from an acquisition pursuant to a confirmed plan of reorganization which effectuates a discharge of the seller under sections 524 and 1141 of the Code, either of which may include a full release of the buyer, the seller's desire to raise cash to avert a bankruptcy filing often makes the distressed acquisition an exercise in the art of the possible.

Structuring Can Be Essential

If, despite the risks, the transaction is to be structured as an out-of-court purchase, there are advantages and drawbacks to various alternatives. The buyer should consider:

- Obtaining an appraisal, an expert valuation and/or a fairness opinion regarding the transaction to provide a contemporaneous assessment regarding the equivalency of the value paid and the basis for the seller's solvency;
- Requiring a robust sales and marketing process, either before there is a deal or as an after-the-fact "go-shop";
- Memorializing the extent to which there is evidence that the transaction represents the highest price reasonably available under the circumstances or provides unique consideration, such as continuing access to books, records and employees, licensing back of intellectual property or distribution rights to the seller, financing for the operations that otherwise is not obtainable in the market or synergies only available to the strategic buyer;
- Providing for a "holdback" from the purchase price against which to set off breaches under the sale agreement, an ask that will need to be evaluated against the risk of losing the deal or having a holdback so large in amount as to run the risk that even a closed sale could be characterized as an installment sale that may be subject to rejection under section 365 of the Code;
- Requiring a form of "keep-well" if the seller has a significant and financially healthy shareholder, whether by backstopping selected representations, promising to keep the seller solvent for a period of time or indemnifying the acquirer against any potential fraudulent transfer claims;
- Providing for payment in cash, rather than stock of the buyer, may help to protect against successor liability and serve to fix the value of the consideration, ensuring it does not appear inadequate in hindsight; n29
- Drafting unequivocal language to identify the specific liabilities, if any, assumed (*i.e.*, list those leases and the like to be assumed) and expressly disclaiming the assumption of any liabilities except those listed;
- If there are liabilities not assumed and the purchase is of all or substantially all of a business, if feasible, reserving for or paying unassumed liabilities out of the purchase price; n30
- Diligencing and documenting projections demonstrating that there will not remain any unpaid creditors and that the entity will be solvent;
- In a private transaction, if feasible, making a public "break" by changing locations, name, top management, the employees who deal with creditors and customers, the telephone number, or other public aspects of the business or otherwise make it clear to customers and suppliers that they are dealing with a new entity; and
- Avoiding a continuing equity interest or employment agreement with the new entity in favor of the prior owners.

Finally, the preferred structure for many of the leveraged acquisitions consummated over the last few years - buying the target by means of a newly created vehicle that has no assets or business other than those purchased and financing the purchase with as much debt as the target's business will support - is likely to substantially increase the risks of a distressed acquisition. It may be impractical to follow many of these suggestions; nevertheless, they are offered as guideposts for potential solutions to minimize the out-of-court risk.

363 Sales

A. Outside the Ordinary Course of Business - section 363(b)

Section 363 of the Code authorizes a debtor in possession or a trustee to sell assets out of the ordinary course of business "after notice and a hearing." The form and extent of notice provided in connection with a motion to approve a sale under section 363, together with the evidence presented in support of and the order approving the sale, are critical to the acquirer.

Sales of substantially all of the debtor's assets under section 363(b) present the potential, depending on which side of the aisle one falls on, for avoiding a liquidation and saving a business or for avoiding the protections required by the plan confirmation process, including the requirements that creditors vote to accept a plan under sections 1126 and 1129(a)(8). n31 Most courts will approve a sale of all or substantially all of the debtor's assets outside of a plan under section 363 in appropriate circumstances, provided that the seller/debtor demonstrates sound business reasons for the sale. n32 And recent decisions have made it clear that, where the assets are in jeopardy of "walking out the door" or losing value, a bankruptcy court can act quickly to preserve the business and going concern value. The key to keep in mind is that when the terms of a proposed sale also dictate the terms of distributions to creditors, some courts have refused to approve proposed sales of substantially all of the debtor's assets under section 363 and required that the sale

be consummated pursuant to a plan. n33 While some commentators have decried the recent decisions approving sales under section 363 as outliers or the harbingers of a brave new world, the reality seems more prosaic.

As the Bankruptcy Court in the General Motors case made clear, "[n]either the Code, nor the caselaw - especially the caselaw in the Second Circuit - requires waiting for the plan confirmation process to take its course when the inevitable consequence would be liquidation. Bankruptcy courts have the power to authorize sales of assets at a time when there still is value to preserve - to prevent the death of the patient on the operating table." n34 In considering the factors for approval of a sale of all or substantially all of the assets of the business, the General Motors court reviewed the factors listed in the Second Circuit's decision in *Lionel* n35 and then added four of its own:

1. Does the estate have the liquidity to survive until confirmation of a plan?
2. Will the sale opportunity still exist as of the time of the plan confirmation?
3. If not, how likely is it that there will be a satisfactory alternative sale opportunity, or a stand-alone plan alternative that is equally desirable (or better) for creditors?
4. Is there a material risk that by deferring the sale, the patient will die on the operating table?

The cases under section 363(b) are perhaps best understood as factual variations on the theme of whether a proposed sale actually is in the "best interest" of the debtor and its creditors, whether the sale requires the compromise of other rights the estate or its creditors may hold and whether there is another viable alternative. In the final analysis, if the sale is a legitimate exercise of the debtor's business judgment, is negotiated at arm's length, does not waive, release or compromise any rights the estate may have against third parties and does not limit the distribution of the proceeds from the sale, it is likely to be approved. And even where the sale compromises rights, releases third parties or as a practical matter limits the proceeds available for distribution, a sale 363 sale can and should be approved where the assets of the estate are deteriorating in value with the passage of time or where the only option is the immediate liquidation of the business to be sold. n36

B. Free and Clear - section 363(f)

Once a bankruptcy court has determined that a sale may proceed under section 363(b), the court may also order that the sale be "free and clear" of any interest in property of an entity other than the estate under section 363(f) if one of the five conditions specified therein is satisfied: (1) the property could be sold free and clear of the interest in question under applicable non-bankruptcy law; (2) consent; (3) the interest is a lien and the sale price exceeds the amount of all liens on the property to be sold; (4) the interest is in bona fide dispute; or (5) the holder of the interest could be compelled, in a legal or equitable proceeding, to accept a monetary satisfaction of such interest. If any one of these standards is met, the trustee or debtor in possession may consummate the sale free and clear of the liens, claims and rights at issue. n37

Section 363(f)(1) is rarely used since absent consent (or in the case of a lien, payment in full), non-bankruptcy law generally does not permit sales free and clear of another's interest. Consent to a proposed sale may be implied or deemed to exist if a claimant fails to timely object to a proposed sale, n38 making the form and service of notice of the sale on likely claimants of critical importance. In addition, in the *Chrysler* case, the complaining lenders were deemed to have consented because they were part of a lending syndicate and the agent and other lenders had consented for the syndicated pursuant to the terms of the loan documents. n39

Where the assets are to be sold free and clear of liens under section 363(f)(3), the cases are divided regarding whether the sale must exceed the face amount of the debt secured by the property to be sold, n40 or whether the sales price must exceed only the "value" of the secured claim as limited by the value of the collateral. n41

Section 363(f)(5) has served as an additional grounds for selling property free and clear of liens, but has also been

applied to permit a sale free and clear of other interests. n42 Some courts have held that the consent of a secured lending syndicated or the debtor's demonstrated ability to satisfy the "cram down" standards of section 1129(b) of the Code if the proposed sale were part of a plan of reorganization meets the standard that an objecting secured creditor could be compelled to accept a monetary satisfaction of its interest. n43

C. Good Faith Purchaser on Appeal - section 363(m)

Section 363(m) of the Code provides, in pertinent part, that the reversal or modification on appeal of an order authorizing an acquisition "does not affect the validity of a sale . . . to an entity that purchased . . . in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale . . . were stayed pending appeal." The result of section 363(m) is that a buyer may rely upon the bankruptcy court's order to close a sale and thereby, in effect, moot any appeal therefrom. n44

The statutory mootness set forth in section 363(m) is available only to good faith purchasers. n45 Courts have interpreted the "good faith" requirement under section 363(m) to mean one who purchases both in good faith and for value. n46 Lack of good faith is generally determined by fraudulent conduct during the sale proceeding, n47 and "a purchaser's good faith 'is shown by the integrity of his conduct during the course of the sale proceedings.' [citations omitted] A good faith finding is precluded if fraud, collusion or attempts 'to take grossly unfair advantage of other bidders' are present." n48

Any party wishing to preserve its rights to set aside an order authorizing a sale (including the original purchaser if another's bid is approved) under section 363 should act quickly in seeking a stay of the order pending appeal pursuant to *Rule 8005 of the Federal Rules of Bankruptcy Procedure*. The general rule is that a stay must be granted before the sale is completed. n49 Failure to obtain a stay moots any appeal from such an order. n50 There are a few instances where failure to obtain a stay does not render an appeal moot. For example, where real property is sold to a creditor subject to a right of redemption or where state law would otherwise permit the transaction to be set aside. n51

There is some authority for the proposition that section 363(m) will not protect the buyer against a lienholder who was not given notice of the sale, n52 although the Court of Appeals for the Seventh Circuit held that a sale order could not be challenged by a lienholder on the grounds of improper notice eighteen months after the order was entered, holding that section 363(m) protects the purchaser only during the time period for an appeal and does not address the scope of collateral relief which is governed by *Federal Rule of Civil Procedure 60(b)* as made applicable by Bankruptcy Rule 9024. Thus, once the time for appeal has run, the Edwards court held, a sale order can only be collaterally attacked within the parameters of Rule 60(b), even on the grounds of improper notice. n53 Finally, some courts have held that expressly conditioning a sale upon a "final, non-appealable order" may waive the protection accorded a good faith purchaser under section 363(m), even where a stay has not been sought. n54

Contracts and Leases - section 365

The prospective purchaser should also consider the potential benefits provided by section 365 of the Code in structuring an acquisition. Where a seller's assets include valuable leases, licenses, n55 franchises, options, mineral rights, output or other contractual agreements, it may be impractical to negotiate for and economically obtain the consents which may be required to transfer these rights in an out-of-court purchase. Section 365 of the Code permits the assignment of leaseholds and contractual rights (with exceptions for inherently unassignable contracts such as those for personal services, certain nonexclusive intellectual property rights and financing agreements or accommodations) notwithstanding a contractual provision on assignment.

A lease or executory contract may be assigned notwithstanding defaults under the terms of the agreement, provided that the defaults are cured and the buyer demonstrates the ability to perform under the terms of the agreement in the future. The issues that can and do arise under section 365 are many and varied, and a prospective acquirer would be well

advised to consider them if there are leaseholds or contractual rights material to the acquisition. n56

Time for a Deal

Prospective purchasers usually try to negotiate for "break-up" or "topping" fees, expense reimbursement provisions, overbid timing and procedures, minimum overbid prices and/or a right of first refusal because they are understandably concerned that the first offer will be used as a "stalking horse" for other bidders and that they will be compensated for the substantial time, expense, fees and/or lost opportunity costs to be incurred in performing their due diligence. Any such protection is not enforceable unless and until approved by order of the Bankruptcy Court as it is a "use" of property of the estate outside of the ordinary course of business for which court approval is required under section 363(b) of the Code.

Thus, most substantial sales are a two-step process in bankruptcy. First, the debtor must file, and the Court must grant, a motion to establish overbid protection and to approve any break up protection or other fees payable to the proposed buyer in order for the buyer to be able to rely on these provisions. Second, a motion to sell the assets to the buyer on the terms negotiated must be separately approved.

There is no direct statutory authority or guideline for the granting of a motion for overbid procedures and protection and there have been relatively few bankruptcy decisions directly considering the validity of overbid procedures and protection. Despite this lack of guidance, the approval of some form of buyer protection has become relatively standard in a bankruptcy context, n57 although the payment of break-up fees, particularly if in addition to the reimbursement of expenses, is a controversial aspect of buyer protection subject to higher scrutiny or disallowance. n58

Historically, three different standards emerged regarding the propriety of break-up and topping fees. First, the *Hupp* court identified seven factors to be weighed in determining whether to approve a requested break-up fee. n59

- (1). Whether the fee requested correlates with a maximization of value to the debtor's estate;
- (2). Whether the underlying negotiated agreement is an arm's-length transaction between the debtor's estate and the negotiating acquirer;
- (3). Whether the principal secured creditors and the official creditors committee are supportive of the concession;
- (4). Whether the subject break-up fee constitutes a fair and reasonable percentage of the proposed purchase price;
- (5). Whether the dollar amount of the break-up fee is so substantial that it provides a "chilling effect" on other potential bidders;
- (6). The existence of available safeguards beneficial to the debtor's estate; and
- (7). Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors in fact oppose payment of the break-up fee.

A "best interests of the estate" standard was introduced by the *In re American West Airlines, Inc.* decision n60 where the court held that fees should be considered in light of "whether the interests of all concerned parties are best served by such a fee." n61 Finally, the Third Circuit developed a different approach to examining break-up fees in *In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999) finding that such fee arrangements are reviewable as administrative expenses under Section 503(b) of the Code and allowable only if the fees are actually necessary to preserve the value of the estate. n62

The rationale for approving some form of protection for the buyer is obvious. The bankruptcy process necessarily entails some delay between the time an agreement is reached with the debtor and the time the agreement is binding upon the debtor and there are additional constituencies with, and a keen interest in, obtaining a higher offer. Moreover, where

an initial bid has been negotiated, other bidders can submit a slightly higher bid at a fraction of the cost the initial bidder incurred by minimal modifications to the sale agreement which has become a matter of public record as it has been submitted for court approval. Thus, potential purchasers are understandably concerned that the first offer will be used as a "stalking horse" for other bidders. Without some assurance that its bid will not be "shopped" to other prospective buyers and that it will be compensated for the substantial time, expense, fees and/or lost opportunity costs to be incurred in performing its due diligence, a credible buyer may be reluctant to make the initial bid and the marketability of the debtor's assets can be adversely and materially affected.

There are no hard and fast rules regarding the kind of buyer protections that will be approved by the court, although the case law provides some guidelines with which a prospective acquirer should be familiar. In general:

- the reimbursement of the actual fees, costs and expenses incurred by the buyer should not be controversial, particularly not if limited to no more than the amount by which any overbid exceeds the initial bid;
- a break-up fee should not exceed 1%-3% of the purchase price or 50% of the overbid amount, whichever is less, and should be payable only in the event that the sale fails to close because a competing bid is approved;
- the requirements of a minimum overbid should be reasonable, as should the timing for submission of competing bids; and
- a right of first refusal may be viewed as "chilling" and therefore controversial, but a provision that after the first overbid, subsequent overbids may be in any amount or need only exceed the last bid by a lesser amount than that required for the first overbid typically is more acceptable.

It should be noted that this area is one which falls squarely within the reasonable discretion of the bankruptcy judge, since it can be very difficult, if not impossible, to obtain appellate review of a decision to permit (or not to permit) break-up fees or other overbid protection. n63

Rules of the Road

Once the acquirer has decided to proceed with a consensual purchase of assets from a bankruptcy estate under section 363, the structure of the transaction (in ways other than overbid protection and break-up fees) can be critical to minimizing the risks of an in-court purchase.

- A buyer should independently determine the identity of all persons claiming a security interest in the assets to be purchased to ensure proper notice. This includes not only pre-petition liens, but also possible post-petition security interests granted, lienable taxes, possible mechanic's or other hidden liens or reclamation claims. The buyer and its counsel should review the docket and proceedings in the bankruptcy case for possible post-petition liens granted. n64
- The acquirer should customize its bid. A purchaser should try to include consideration that is unique and difficult to replicate or that is not susceptible to precise valuation. A bid of \$100 million cash with a 5% overbid requirement can be defeated by a \$105 million cash offer. A purchaser who can bring unique consideration to the table increases its chances for success, e.g., consider purchasing secured debt (at a discount), assuming priority or secured liabilities or providing tangible upside to the estate. n65
- An all cash purchaser should try to reserve its best and last offer for the courtroom, especially if there are likely to be competing bids. Irrespective of court-approved procedures, a late bid that is demonstrably higher and better is more likely than not to be entertained by creditors and the court. If the original buyer can sweeten its bid at the last minute, the buyer stands a better chance of prevailing at a courtroom auction.
- An acquirer should make sure other constituencies in the case are informed and, to the extent feasible, on board. A committee that has been intimately involved in the negotiations is less likely to shift gears and support a late bidder.
- The acquirer should make sure there is ample evidence of and a finding regarding the acquirer's "good faith." n66
- The acquirer should require that the notice of the sale and the order approving the sale be in form and substance acceptable to the acquirer and its counsel as a condition to closing the transaction.
- If the acquirer wishes to rely on section 363(m), the agreement should not be conditioned upon the entry of a final, nonappealable order or at least not unless the condition is waivable at the discretion of the buyer. Fair warning: if the agreement is not so conditioned, the acquirer may be bound to close notwithstanding the pendency of an appeal and may have to take its chances with section 363(m) and otherwise on appeal.

Ethical Considerations

Collusive bidding carries heavy penalties, both civil and criminal. Section 363(n) of the Code permits the avoidance of a sale or recovery of damages (including costs, attorneys' fees and possibly punitive damages) from a potential bidder at such sale if "the sale price was controlled by an agreement among potential bidders."

In addition, *section 152 of title 18 of the United States Code* imposes up to \$5,000 in fines upon and/or imprisonment for up to 5 years for any person who, among other things, "knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11" or "knowingly and fraudulently gives, offers, receives or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof, for acting or forbearing to act, in any case under title 11."

Thus, agreements which may be valid outside of bankruptcy, such as a deal among bidders, whose real aim is to acquire different parts of the debtor's business, to team up or "carve up" the assets in question post-sale, or a deal to pay consideration to the equity holders in the form of a consulting agreement or a lease of real estate or other assets owned by them, can run afoul of the Code and of the related criminal provisions of title 18. Full disclosure of all forms of consideration paid to any person is always required in a bankruptcy sale.

Plan Confirmation Sales

A plan of reorganization may provide for the transfer of some or all of the debtor's assets or equity and for the settlement and discharge of the debtor's liabilities. Thus, a prospective acquirer can obtain ownership or control of either the debtor entity or the assets of the debtor, free of all liabilities, claims or interests that pre-date the confirmation of the plan of reorganization. n67 There are advantages and drawbacks inherent in the plan process from the buyer's standpoint of course. The primary disadvantages are the substantial costs and frequently long delays the plan process entails, although in some circumstances, it may be possible to reduce the disadvantages by means of a pre-packaged or pre-negotiated plan.

Where management or existing equity is disinclined to negotiate a consensual acquisition, where the consideration to be paid by the buyer is other than cash (i.e., is payable over time or is in equity securities), or where there is likely to be an objecting class of creditors (particularly secured creditors in a short sale or creditors whose debt will be reinstated on its original terms), the proposal of a plan (frequently in conjunction with existing creditors and/or coupled with the purchase of claims) may be a more practical avenue to accomplishing the acquisition than a sale pursuant to section 363 of the Code. In addition, even where the acquisition is consensual, the plan process can minimize or eliminate the risk of competing bids inherent in the section 363 "auction" process, at least if the plan is proposed during the debtor's exclusivity period. Finally, and perhaps most importantly, the plan process provides various alternatives for confirmation over the objection of one or more creditors.

The acquisition of the debtor entity under a plan as opposed to a sale under section 363 has at least the following advantages:

- The purchaser may pay a portion of the purchase price by issuing new securities to shareholders or creditors;
- The debtor may cure and reinstate defaulted obligations upon their original terms;
- The debtor may be able to restructure existing debt and "cram down" one or more classes of creditors;
- After exclusivity has expired, the acquirer may be able to confirm a plan to acquire ownership or actual control of the debtor even over the objection of the debtor and its management;
- Confirmation of a plan may provide the acquirer and the reorganized debtor with greater protection from successor liability concerns;
- A sale pursuant to a plan can be accomplished without documentary, stamp or similar state law taxes, *11 U.S.C. § 1146(a)*; n68
- A sale under a plan can be consummated over the objection of (1) a class of creditors that is not impaired under

section 1124, n69 (2) any class of creditors that is impaired but that consents by a majority in number and two-thirds in amount under section 1129(a), or (3) any class of creditors so long as the plan meets the standards for confirmation (including that at least one impaired class of creditors have accepted the plan), is fair and equitable and does not discriminate unfairly against the impaired class under section 1129(b). n70

While the consummation of an acquisition through a plan of reorganization may be most desirable from the standpoint of minimizing legal risk, it can present the greatest business risk in that the business may deteriorate materially during the necessary delays prior to confirmation. If the acquisition is consensual, the potential acquirer should carefully draft and include covenants for the operations of the business pending approval of the sale n71 and should consider negotiating timeframes and deadlines for the occurrence of critical events, including the filing of a plan and disclosure statement, financing the business on a post-petition secured basis to ensure sufficient working capital until confirmation and the possibility of an interim management agreement which provides the prospective purchaser with some measure of control over critical business decisions. The purchaser will need to keep in mind that until court approval is obtained and the sale is consummated, however, all operations of the business will remain subject to the strictures upon the operations of a debtor in possession.

Prepackaged Plans

Prepackaged bankruptcy plans offer many of the advantages of a bankruptcy transaction, combined with the significant time and cost savings offered by a transaction that takes place outside of bankruptcy. Because the debtor is only in bankruptcy for a short period of time, there is limited time for committees to form and opponents to put forward a meaningful objection to a proposed plan of reorganization which may include the sale of certain assets. A prepackaged plan also offers many of the advantages of a traditional bankruptcy (including the automatic stay of all litigation, the ability to sell assets free and clear of all liens and the ability to provide the participants in the process with third-party releases).

A prepackaged bankruptcy plan is one where a distressed company negotiates and solicits acceptances of its plan of reorganization prior to the commencement of its bankruptcy case. The distressed company works to obtain approval of the prepackaged plan from more than half in number and two-thirds in amount of each class of debtholders whose rights are modified under the prepackaged plan. This approval threshold satisfies the plan voting requirements under the Code. The distressed company then voluntarily commences a Chapter 11 bankruptcy case in order to obtain prompt court approval of the plan based on the prepetition vote under section 1126(b). The bankruptcy court's approval binds any dissenting debtholders and allows the distressed company to cram down the plan on shareholders. The cram-down feature permits a debt-for-equity exchange that otherwise would require shareholder approval.

Despite its advantages, there are significant risks associated with prepackaged plans. For example, trade creditors may refuse to extend credit during the prepetition solicitation period and as a result worsen the distressed company's cash flow problems and push it closer to a traditional bankruptcy proceeding. Another risk is that the court approval process can become drawn out if opposition to the prepackaged plan is able to organize itself quickly, particularly in light of the ready markets for trading in distressed debt. Finally, the court's approval of a prepackaged plan can depend in part on the distressed company's ability to make the bankruptcy court comfortable with the prepetition process. This can be difficult because a prepackaged plan is typically drafted and negotiated by the distressed company and several self-appointed creditor groups without any input or supervision by the bankruptcy court.

Purchasing Claims

The filing of a bankruptcy frequently creates an active market in claims against the debtor for profit. The purchase of claims has been utilized, both successfully and unsuccessfully, as a vehicle for acquiring ownership or control of a financially troubled business. The strategy is scarcely novel, n72 although the nomenclature and prevalence of so-called "loan-to-own" investment strategies is a more modern development. A potential acquirer usually considers the purchase of claims (i) as one possible means of controlling the voting in critical classes in connection with a plan of

reorganization; or (ii) if the acquirer otherwise is a stranger to the bankruptcy, as a means of obtaining standing to propose its own plan of reorganization or to appear and be heard on other matters in connection with the bankruptcy proceedings.

Generally speaking, the purchase of claims in a bankruptcy case is not limited by the Code (although certain claims may constitute "securities" within the meaning, and therefore their transfer is subject to the provisions, of federal and state securities laws) and, in fact, is expressly permitted under the Bankruptcy Rules. *Rule 3001(e) of the Federal Rules of Bankruptcy Procedure* provides for notice of a claim transferred by or to an individual creditor (other than publicly traded notes, bonds or debentures) while Rule 2019 requires extensive disclosure from claimants who engage in concerted action and from the professionals that jointly represent such a group or "ad hoc" committee. n73 The long-established rule has been that, absent misconduct, a claim purchased at a discount by one who is not a fiduciary is enforceable at its face value, although the priority of the claim under section 507 may be personal to, or affected by the conduct of, the holder or transferor. n74

The acquisition of "control" over the debtor by purchasing claims becomes possible once a bankruptcy is filed since the identity of claimholders and the amounts of their claims (at least according to the debtor) are matters of public record, but there are relevant provisions of the Code which limit the extent of control that the purchase of claims can provide. A prospective purchaser seeking to acquire control needs to keep firmly in mind the provisions of, among others, sections 1121, 1125, 1126 and 1129(b) of the Code n75 and ought to be thoroughly familiar with the principles and cases in this area, since there are numerous traps for the unwary buyer. n76

Section 1121 of the Code provides for a period of exclusivity during which only the debtor may file and solicit votes in favor of a plan of reorganization. While the initial exclusivity period is only 120 days for the filing of a plan and 180 days for solicitation if a plan is filed, *11 U.S.C. §§ 1121(b) and 1121(c)(3)*, those timeframes can be and frequently are extended by order of the Bankruptcy Court in a case of any magnitude or with any realistic prospect of reorganization. Thus, the purchase of claims gives a prospective acquirer of the business little more than some negotiating leverage with the debtor unless and until the 'debtor's exclusivity period has ended.

Section 1125 of the Code specifies that no one may solicit acceptances or rejections of a plan of reorganization without the prior transmission of a disclosure statement containing "adequate information" to permit an informed judgment on whether to accept or reject a proposed plan. Section 1126 of the Code specifies the requirements for obtaining acceptances of a proposed plan of reorganization from each class of claims against the debtor. In order to obtain the acceptance of a class, a majority in the number of holders of claims in such class plus the holders of at least two thirds in amount of the claims in such class must vote to accept the proposed plan. Thus, an acquirer cannot ensure "control" over the terms of a plan of reorganization unless and until (i) the exclusivity period has expired (or, during the exclusivity period in conjunction with a "friendly" acquisition); (ii) the acquirer (or other proponent) has been authorized to solicit acceptances of an acceptable plan; and (iii) the acquirer has purchased the requisite number and amount of claims in each class or has negotiated terms that are acceptable to the requisite number and amount of claims in each class.

Section 1129(b) of the Code provides for the confirmation of a plan despite the rejection of the plan by a class or classes of creditors if the prerequisites of that section are met. Thus, even if a prospective acquirer were to purchase all or a majority of the claims in a given class, the debtor may be able to confirm a plan of reorganization that is not to the prospective buyer's liking by using the provisions of section 1129(b) or by confirming a plan that does not impair the class of creditors in question. n77

While any number of participants have developed some facility with concepts such as "fulcrum securities" and "loan to own," the strategy in fact requires a thorough grounding in bankruptcy principles. Acquiring claims as a means to acquiring a business of course is always subject to the debtor's ability to repay the debt, the priorities afforded other claims under the Code and the ability of the debtor to modify the terms of the indebtedness under a plan of reorganization that can be "crammed down" or confirmed over the objection of a class of creditors. Moreover, a creditor

who buys claims for an improper purpose or in an improper manner always runs the risk that it will be deprived of the benefit of its bargain by the bankruptcy court, which ultimately must allow or disallow and may subordinate, designate or limit claims on equitable grounds. n78 In the depths of the downturn early in 2009, there was some movement toward a "DIP to own" rather than a simple "loan to own" strategy, partly as an indicator of how far values dropped and partly because the claims of a "DIP" (debtor in possession) lender are approved by the court, making them relatively impervious to vulnerabilities in perfection, to fraudulent transfer attack or to cram down plans.

In addition, market participants who seek to act collectively are subject to the disclosures required under Bankruptcy Rule 2019. The current frontier in this area is the extent of disclosure required of public bondholders who trade and act in concert as a group under Bankruptcy Rule 2019. The provisions of the rule clearly require disclosure of the identities of those who are jointly represented but the applicability of Bankruptcy Rule 2019(a)(4), which requires, among other things, the disclosure of the amounts of claims held, the times acquired, the amounts paid and any sale or disposition thereof, has been a controversial topic. n79 Those who trade in claims argue that information is sensitive, proprietary and confidential but if so, the harm should be easy enough to avoid. The disclosure only attaches to those who seek to act jointly and to exert collective bargaining power in the bankruptcy.

While there are many other concerns and considerations in structuring an acquisition utilizing the purchase of claims to acquire control, the key issues really do go to notice, disclosure and process.

Conclusion

Distressed M&A - a little-known art practiced by but a few over the last decade - is squarely back onto center stage. Client meetings that once focused on rights plans and "go-shops" have been replaced by discussions of fraudulent conveyance risk, 363 sales and plans of reorganization and the "failing company" defense. As with every economic downturn, the broad outlines of the terrain are familiar - not really a brave new world at all -- but the deals that are being done will continue to make law and fill the aces and spaces of the winning hands.

ADDITIONAL RESOURCES:

For more on mergers and acquisitions, see M&A Practice Guide, Chapter 2, "Planning M&A Transactions"

For more on antitrust, see Gotts and Asker on Distressed Entities and HSR, *2008 Emerging Issues 2377*

For more on bankruptcy, see Collier on Bankruptcy

[Return to Text](#)

n1 See, e.g., *In re Chrysler LLC*, 2009 U.S. App. LEXIS 12351 (2d Cir. N.Y. August 5, 2009) *affing In re Old Carco LLC (f/k/a Chrysler)*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009); *In re General Motors*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009); *In re Lehman Bros. Holdings, Inc.*, 2008 Bankr. LEXIS 4154 (Bankr. S.D.N.Y. November 6, 2008).

n2 The Bankruptcy Code is Title 11 of the United States Code. References to statutory sections, unless otherwise specified, are references to the applicable section of Title 11.

n3 Prepetition sales have been the subject of highly publicized litigation, the most recent of which is the complaint filed by the unsecured creditors committee in *In re Lyondell Chemical Company*, Case No. 09-10023 (REG) (Bankr. S.D.N.Y.), against lenders, directors, shareholders, advisors and others seeking to recover damages to creditors arising from the leveraged acquisition of Lyondell by Basel more than 2 years before the bankruptcy was commenced on fraudulent transfer, breach of duty and various other tort and equitable grounds. *See also, In re ION Media Networks, Inc.*, Case No. 09-13125 (JMP) (Bankr. S.D.N.Y. 2009); *In re Mervyn's Holding, LLC*, Case No. 08-11586 (KG) (Bankr. D. Del. 2008) . Transactions that have been approved under other insolvency regimes also have been the subject of attack and litigation in bankruptcy proceedings. *See, e.g., In re Washington Mutual Inc.*, Case No. 08-12229 (MFW) (Bankr. Del.) and *Washington Mutual, Inc. and WMI Investment Corp. v. Federal Deposit Insurance Corporation*, No. 09-cv-00533 (D. D.C. filed March 20, 2009) in which the former parent and bank holding company of a bank in receivership filed for bankruptcy and attacked the sale of the assets and business by the FDIC as receiver. And at least one court has held that "free and clear" does not really mean "free and clear" in the context of a credit bid to a senior secured creditor. *See, e.g., Clear Channel Outdoor v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (Bankr. 9th Cir. 2008).

n4 The sales process is of course as important in a sale by a solvent public company to mitigate against the reverse litigation risk - a shareholder suit that the price paid was not enough and that the Board breached its duties by not obtaining a higher price.

n5 A recent example is the professional fees and expenses paid by the debtors in the US chapter 11 bankruptcy case of *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 (JMP), which totaled more than \$260 million for the first nine months of the case according to filings made by the debtor with the Securities & Exchange Commission. It appears that this amount is in addition to the fees paid in the companion liquidation proceeding of Lehman Brothers itself under SIPC and those paid in the bankruptcy proceedings involving Lehman entities in various jurisdictions outside of the United States.

n6 In *In re Old Carco LLC (f/k/a Chrysler LLC)*, *supra* note 5, Case No. 09-50002 (AJG)(Bankr. S.D.N.Y.), there were objections first to the overbid and sales procedures order which resulted in appeal to the district court and motions for the appointment of an examiner and a trustee and then objections to the sale itself which resulted in appeals to the Circuit Court and a petition for certiorari to the United States Supreme Court.

n7 In *In re Lehman Brothers Holdings, Inc.*, *supra* note 5, the Bankruptcy Court recently granted motions to take discovery from the purchaser under a section 363 sale approved by the Bankruptcy Court itself in the proceeding in September, 2008. *In re Lehman Bros., Inc.*, 2008 Bankr. LEXIS 3543 (Bankr. S.D.N.Y. Nov. 26, 2008) .

n8 One result has been the reappearance of financing conditions in a number of acquisition agreements.

n9 Certain types of critical agreements, such as nonexclusive licenses of patents or copyrights, may not be assumable even in a bankruptcy without the consent of the licensor. *See, e.g., Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747 (9th Cir. Cal. 1999); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 268 (4th Cir. Md. 2004); *In re Golden Books Family Entertainment*, 269 B.R. 311 (Bankr. D. Del. 2001).

n10 Given the widely publicized process that most distressed sellers run in order to provide a basis for the fairness of the transaction accepted by the board and to mitigate the risk of fraudulent transfer litigation, the debt at various levels in the target's capital structure will often trade and trade quickly into the hands of distressed debt investors. The benchmark imposed by these investors to support a sale transaction is not necessarily predicated on intrinsic value but is often affected by the trading window and opportunity, by the perception of what other parties have at stake, by the subjective determination of what hold up value is in play or on what value the investor may place on the alternative of confirming a standalone debt for equity plan.

n11 Every state and the Code each has some variant of these laws - originally predicated on statutory or common law based upon the Statute of 13 Elizabeth, Ch. 15 (1570) and then on the model codes - the uniform fraudulent conveyance act ("UFCA") and the uniform fraudulent transfer act ("UFTA"), which provide a basis upon which to challenge a transaction for several years after the transaction closes. Upon the filing of a bankruptcy case, the estate may proceed either under the federal fraudulent transfer provisions of 11 U.S.C. § 548 or under state fraudulent transfer laws made applicable to the bankruptcy proceeding by the provisions of 11 U.S.C. § 544(b).

n12 A fraudulent transfer may be avoided if made or incurred with the "actual intent" to hinder, delay or defraud creditors or may be avoided as a constructively fraudulent transfer if three basic conditions are met. Those are (a) an interest in assets was transferred or an obligation was incurred, (b) by the debtor who did not receive a reasonably equivalent value therefore, and (c) the debtor was either before or after giving effect to the transaction insolvent. The third element - insolvency - is measured by balance sheet insolvency, liquidity or capitalization and failing any one of the three is sufficient to meet this element for avoidance of the transaction. The law in those states which have not enacted either the UFCA or the UFTA may not cover the incurring of an obligation as opposed to the transfer of an asset (so that, for example, the issuance of an upstream guaranty would not itself be open to challenge although the granting of a security interest to support the guaranty would be). *See, e.g., Ga. Code Ann. § 18-2-22*. The statute of limitations for challenging a transfer under state fraudulent transfer laws typically is three (UFCA) or four (UFTA) years from the date of the transfer.

n13 *See e.g., Chemical Bank v. Security Pac. Nat'l Bank*, 20 F.3d 375 (9th Cir. 1994). The process followed for a sale is not only important potential inoculation against a fraudulent transfer attack is also important in persuading a bankruptcy court that an abbreviated process under section 363 is an appropriate exercise of the seller's business judgment. *See e.g., In re Chrysler LLC*, 405 B.R. 84, 105 (Bankr. S.D.N.Y. 2009); *In re General*

Motors Corp., 407 B.R. 463, 467 (Bankr. S.D.N.Y. 2009). A buyer does need to be careful in the process since, for example, a buyer in an out of court transaction that requests a solvency opinion and closes in its absence however may have actually increased the likelihood that a challenge to the transaction on fraudulent transfer grounds would succeed.

n14 *La Fountain v. Webb Industries Corp.*, 951 F.2d 544, 546-57 (3rd Cir. 1991); *Florum v. Elliott Mfg.*, 867 F.2d 570, 575 n.2 (10th Cir. 1989) (citing Fletcher, *Cyclopedia of the Law of Private Corporations* § 7123.5 (1983)).

n15 *Florum*, 867 F.2d at 575 n.3.

n16 *See, e.g., Chaveriat v. Williams Pipe Line Co.*, 11 F.3d 1420, 1425 (7th Cir. 1993) (Posner, C.J.) ("The common law rule that the sale of assets does not carry the seller's liabilities with them is qualified by bulk-sale statutes. And it is merely a default rule—a rule that courts use to complete contracts when the parties have failed to specify the allocation of some risk. If, not trusting the default rule, or wanting to vary it, the parties have specified whether liabilities are to be retained by the seller or assumed by the buyer, the court will enforce the specified allocation and the default rule drops out.").

n17 *See, e.g., U.S. v. General Battery Corp. Inc.*, 423 F.3d 294, 305 (3rd Cir. 2005) (applying the four factor test used in the majority of jurisdictions, which finds that a de facto merger occurs where there is (i) a continuation of enterprise of the seller's corporation, so that there is a continuity of management, personnel, physical location, assets, and general business operations; (ii) a continuity of shareholders which results from the purchasing corporation paying for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation; (iii) no continuation of the seller corporation, which ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practicably possible; and (iv) assumption of the selling corporation's obligations that are ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation.).

n18 *See, e.g., Allied Corp. v. Acme Solvents Reclaiming Inc.*, 812 F. Supp. 124 (N.D. Ill. 1993) (granting summary judgment in favor of the defendant after noting absence of "traditional" factors supporting mere continuation theory, which include "identity of officers, directors, and stock between the selling and purchasing corporation", as well as the "continuity of investors and control", and the "adequacy of consideration in the transfer of assets.").

n19 *See, e.g., Chaveriat v. Williams Pipe Line Co., 11 F.3d at 1425, supra* note 17 ("To avoid a judgment in an impending lawsuit or avalanche of suits the seller might have sold all its assets to a new corporation owned by its predecessor's owners and retained all its liabilities in an assetless shell; if so, then . . . the successor corporation would be liable").

n20 *See, e.g., Simoneau v. South Bend Lathe, Inc., 130 N.H. 466, 543 A.2d 407, 409 (1988)* (rejecting product line theory of successor liability).

n21 *See, e.g., Conway v. White Trucks, 885 F.2d 90, 93 (3d Cir. 1989).*

n22 Section 2102(a) of the Worker Adjustment and Retraining Notification Act (the "WARN Act").

n23 A purchaser may be prohibited from selling goods so produced in interstate commerce, 29 U.S.C. §§ 206 and 207, and will be exempted only if the purchaser acquired the goods for value without notice of the violation and in good-faith reliance upon the seller's written assurance that the goods were produced in compliance with the requirements of the statute. 29 U.S.C. § 215(a).

n24 Hidden liens can include inchoate liens to banks on deposits, landlords on leased premises and contents, taxing authorities (particularly real estate taxes), mechanics and materialmen, producers' liens for oil and gas or agricultural liens for food products.

n25 *International Shoe v. FTC, 280 U.S. 291, 302 (1930).*

n26 *Citizen Publishing Co. v. United States, 394 U.S. 131 (1969).*

n27 U.S. Department of Justice & Federal Trade Commission, Horizontal Merger Guidelines (1992).

n28 *See, e.g., FTC v. Great Lakes Chem. Corp., 528 F. Supp. 84, 96 (N.D. Ill. 1981)* (the court found the

doctrine applicable to failing divisions) and *United States v. Blue Bell, Inc.*, 395 F. Supp. 538, 550 (M.D. Tenn. 1975) (the court found the doctrine inapplicable to failing divisions).

n29 On the other hand, it fixes the amount paid so that there is no argument that the buyer paid more by providing the seller with equity upside.

n30 If the sale is to be consummated as part of a prepackaged plan or if the creditors of the target are not being paid in full as the result of the sale, an all cash transaction may be more vulnerable to valuation disputes or a competing standalone debt for equity swap. The acquisition of claims and the strategies employed to lock up key parts of the capital structure in a situation where classes of creditors may not be paid in full is beyond the scope of this article. From a purely legal standpoint, it is preferable to buy only selected assets and to avoid assuming all of the existing business obligations of a business but that may not be a practical business approach to suppliers and customers.

n31 *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) (discussing tension between requirements of sale approval when it is part of plan and absence of such requirements under § 363(b)); *In re Chrysler LLC*, 2009 U.S. App. LEXIS 12351 (2d Cir. N.Y. August 5, 2009); *In re General Motors Corp.*, 2009 U.S. Dist. LEXIS 61279 (S.D.N.Y. July 9, 2009); *In re Chrysler LLC, supra*, (analyzing *Lionel* and subsequent decisions regarding good cause for approval of a 363 sale and factors to consider in sub rosa plan analysis).

n32 *Id.* See also, *In re Exaeris, Inc.*, 380 B.R. 741, 744 (Bankr. Del. 2008) ("The sale of assets which is not in the debtor's ordinary course of business requires proof that: (1) there is a sound business purpose for the sale; (2) the proposed sale price is fair; (3) the debtor has provided adequate and reasonable notice; and (4) the buyer has acted in good faith."); *In re Castre, Inc.*, 312 B.R. 426 (Bankr. D. Colo. 2004); *Stephens Industries v. McClung*, 789 F.2d 386, 389-90 (6th Cir. 1986). See *Comm. Of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 at 1070- 71, (2d Cir. 1983); *In re Delaware & Hudson Railway Co.*, 124 B.R. 169, 175-76 (D. Del. 1991); *In re Industrial Valley Refrig. & Air Cond. Supplies*, 77 B.R. 15 (Bankr. E.D. Pa. 1987); *In re Coastal Indus.*, 63 B.R. 361 (Bankr. N.D. Ohio 1986); *In re Highway Equipment Co.*, 61 B.R. 58, 60 (Bankr. S.D. Ohio 1986). A number of cases have resulted in the approval of sales of all or substantially all of the assets of a business without published opinions. In the Southern District of New York, for example, see *In re Silicon Graphics, Inc.*, Case No. 09-11701 (MG), Dkt. No. 292; *In re BearingPoint, Inc.*, Case No. 09-10692 (REG); and *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 (JMP), Dkt. No. 258 and in the District of Delaware, see, e.g., *In re Decora Indus.*, No. 00-4459, 2002 WL 32332749, at *3 (D. Del. May 20, 2002).

n33 See, e.g., *Institutional Creditors v. Continental Air Lines Inc. (In re Continental Air Lines, Inc.)*, 780 F.2d 1223, 1227-28 (5th Cir. 1986); *Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983) (motion for approval of sale denied as "sub rosa" plan). See also, *In re Solar Manufacturing*, 176 F.2d 493, 494 (3d Cir. 1949) (Act Case) (sale of substantially all assets

"confined to emergencies"). But see *In re Abbotts Dairies of Pennsylvania, Inc.*, 788 F.2d 143 (3d Cir. 1986); *In re Delaware & Hudson Ry. Co.*, 124 B.R. 169, 176 (D. Del. 1991) (analyzing *Solar* and *Abbotts Dairies* holdings for inconsistencies).

n34 *In re General Motors*, *supra* note 1,407 B.R. at 474.

n35 *In re Lionel Corp.*, *supra* note 31.

n36 In each of *Lehman*, *Chrysler* and *General Motors*, the lack of a viable alternative to the sale other than liquidation was a key factor in the court's approval.

n37 See, e.g., *In re NJ Affordable Homes Corp.*, 2006 WL 2128624, 9 (Bkrtcy. D.N.J. 2006) (statute written in the disjunctive so any one of the conditions is sufficient); *In re Elliot*, 94 B.R. 343, 345 (E.D. Pa. 1988) (same).

n38 *Citicorp Homeowners Services, Inc. v. Elliot*, 94 B.R. 343, 345-346 (E.D. Pa. 1988); *In re Gabel*, 61 B.R. 661, 667 (Bankr. W.D. La. 1985).

n39 *In re Chrysler LLC*, 405 B.R. 84, 102-03 (Bankr. S.D.N.Y. 2009).

n40 See, e.g., *Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC)*, *supra*; *In re Red Oak Farms, Inc.*, 36 B.R. 856, 858 (W.D. Mo. 1984).

n41 See, e.g., *In re Beker Industries Corp.*, 63 B.R. 474, 476-77 (Bankr. S.D.N.Y. 1986) (the "value" of liens must be determined by reference to § 506(a) and, accordingly, a sale for less than the face amount of liens could be approved over objection of a secured creditor).

n42 See, e.g., *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003) (ordering sale free and clear of

tort claims); *In re Old Carco LLC*, *supra* note 39, at 111 (ordering sale free and clear of claims including tort and product liability claims); *In re Crabtree*, 112 B.R. 520 (Bankr. W.D. Okla. 1989) (trustee permitted to sell free of debtor's exemption interest in homestead).

n43 See, e.g., *In re Weyland*, 63 B.R. 854, 861 (Bankr. E.D. Wis. 1986); *In re Hunt Energy Co.*, 48 B.R. 472, 485 (Bankr. N.D. Ohio 1985). But see *In re Stroud Wholesale, Inc.*, 47 B.R. 999, 1002-1003 (E.D.N.C. 1985).

n44 Of course, section 363(m) of the Code does not supplant general principles of mootness and justiciability rooted in the constitutional doctrine that federal courts may hear only live cases and controversies, U.S. Const., Art. III, § 2. Nor does it preclude the issuance of a stay pending appeal with or without bond and of course judges can and sometimes do stay the effect of their own orders in order to afford the opportunity for appellate review, as both the bankruptcy court and the court of appeals temporarily did in the Chrysler matter.

n45 *In re Paulson*, 276 F.3d 389, 392 (8th Cir. 2002); *In re Onouli-Kona Land Co.*, 846 F.2d 1170, 1173 (9th Cir. 1988) ("[b]ankruptcy's mootness rule operates only when a purchaser bought an asset in good faith"). See also *In re First Mortgage Atrium Bldg., Ltd.*, 92 B.R. 202, 207 (Bankr. E.D. Tex. 1988) ("if § 363(m) applies, a good faith purchase is required"); see *In re Citizens Mortgage Invs. Trust*, 25 B.R. 1005, 1007 (D. Mass. 1982) ("[s]ince the order approving sale was not stayed pending appeal, the sale cannot be affected if it was made to a good faith purchaser").

n46 *In re Abbotts Dairies*, 788 F.2d 143, 147 (3d Cir. 1986).

n47 *In re Exennium, Inc.*, 715 F.2d 1401, 1404-5 (9th Cir. 1983); *In re Rock Indus. Mach. Corp.*, 572 F.2d 1195, 1198 (7th Cir. 1978) ("Typically, the misconduct that would destroy a purchaser's good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders").

n48 *In re Chrysler LLC*, 405 B.R. at 106. Though "good faith" in the context of a § 363(b) sale has been defined as "the absence of any lucrative deals with insiders . . .", *In re Indus. Valley Refrigeration and Air Conditioning Supplies, Inc.*, 77 B.R. 15, 21 (Bankr. E.D. Pa. 1987), "it is not 'per se bad faith for [an insider] of the debtor to have an interest in the purchase of the debtor." *In re Apex Oil Co.*, 92 B.R. 847, 869 (Bankr. E.D. Mo. 1988) (quoting *In re Andy Frain Servs., Inc.*, 798 F.2d 1113, 1125 (7th Cir. 1986)). See also *In re Ancor Exploration Co.*, 30 B.R. 802, 808 (N.D. Okla. 1983) (even when the purchaser is an insider, "the Bankruptcy Court should have wide latitude in approving . . . a private sale of all or substantially all of the estate assets not in the ordinary course of business under § 363(b)"); *In re Naron & Wagner, Chartered*, 88 B.R. 85, 88 (Bankr.

D. Md. 1988) (approved the sale of assets "to a corporation controlled by insiders of the seller, which is Debtor's subsidiary"); *In re Kings Inn, Ltd.*, 37 B.R. 239, 243 (*Bankr. 9th Cir. 1984*) (the Court rejected argument that purchase of assets by insider constitutes lack of good faith, stating: "Appellant contends that the Bergendahl family's control of various entities involved in this case and their knowledge and involvement in events which led up to this case preclude them from meeting the test of 'good faith'. The test of 'good faith' has not been interpreted as the appellant argues."). But see *Donovan & Schuenke v. Sampsel*, 226 F.2d 804, 807 (*9th Cir. 1955*), *cert. denied*, 350 U.S. 895 (1955), in which the Ninth Circuit set aside the sale of property to the former president of a bankrupt corporation who had assisted the trustee in managing property of said corporation, stating: "A fiduciary cannot purchase property which he is empowered to sell. . . . Property in custody of a court of bankruptcy has a special status and is sacrosanct. No dealings therein will be tolerated which are tainted with the possibility of unfairness or of conflict between personal desires and trust obligations."

n49 11 U.S.C. § 363(m) (emphasizing that a reversal on appeal of an authorization of a sale of property does not affect the validity of such authorization unless the authorization was stayed pending appeal). See e.g., *U.S. v. Salerno*, 932 F.2d 117 (2d Cir. 1991) (closing of sale rendered moot the appeal from order approving sale); *In re Dial Indus., Inc.*, 137 B.R. 247, 250 (*Bankr. N.D. Ohio 1992*); *In re Kings Inn, Ltd.*, *supra*, (appeal moot when court-authorized bankruptcy sale completed); *In re Dawkins & Assocs., Inc.*, 56 B.R. 691, 693 (*Bankr. M.D. Fla. 1986*).

n50 See, e.g., *In re Ewell*, 958 F.2d 276 (9th Cir. 1992) (the appeal from an order authorizing the sale of estate property that was not stayed pending appeal was moot and had to be dismissed under section 363(m), even though the sale was closed pursuant to the order before the ten day stay period referred to in *Federal Rules of Civil Procedure 62(a)* and *Federal Rules of Bankruptcy Procedure 7062* and *9014* had expired). See also *In re Gilchrist*, 891 F.2d 559, 560 (5th Cir. 1990) (if sale not stayed pending appeal and sale takes place, appeal of sale is rendered moot by § 363(m)); *In re Onouli-Kona Land Co.*, *supra*, (Debtor's appeal from Bankruptcy Court order confirming sale moot where Debtor failed to obtain stay of the order); *In re The Charter Co.*, 829 F.2d 1054, 1056 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1488 (1988); *In re Sax*, 796 F.2d 994, 997 (7th Cir. 1986); *In re Andy Frain Servs., Inc.*, *supra* note 48; *In re Stadium Mgt. Corp.*, 895 F.2d 845, 847 (1st Cir. 1990) (good faith purchaser protected from reversal of sale unless there is stay pending appeal); *In re Met-L-Wood Corp.*, 861 F.2d 1012, 1018 (7th Cir. 1988), *cert. denied*, 490 U.S. 1006 (1989) ("even a reversal on appeal of the order authorizing or confirming the sale will not affect the sale's validity if the buyer was in good faith and the sale was not stayed pending appeal"). See also, *ACC Bondholder Group v. Adelpia Commc'ns Corp.* (*In re Adelpia Commc'ns Corp.*), 361 B.R. 337, 368 (S.D.N.Y. 2007) (stay conditioned upon posting of \$1.3 billion bond). If the parties to the sale can agree to abide by the appeal, such an agreement overrides § 363(m). *Willamette Water Front, Ltd. v. Victoria Station, Inc.* (*In re Victoria Station, Inc.*), 88 B.R. 231 (*Bankr. 9th Cir. 1988*), *aff'd*, 875 F.2d 1380 (9th Cir. 1989).

n51 See, e.g., *In re Mann*, 907 F.2d 923 (9th Cir. 1990) (appeal not moot despite debtor's failure to obtain a stay of a foreclosure sale pending appeal); *In re Onouli-Kona Land Co.*, *supra*, 876 F.2d at 1173; *In re First Mortgage Atrium Bldg., Ltd.*, *supra*, 92 B.R. at 207 (appeal not moot if (i) purchasing creditor at foreclosure sale is a party to the appeal and (ii) statutory rights of redemption exist under applicable state law). In a different context and in a controversial opinion, the Bankruptcy Appellate Panel for the Ninth Circuit also recently held that the appeal by a second lien holder from an order authorizing a credit bid sale to the first lien holder free and

clear of liens was not rendered moot by the closing of the sale. *Clear Channel Outdoor, supra*.

n52 See, e.g., *In re Moberg Trucking, Inc.*, 112 B.R. 362, 363 (Bankr. 9th Cir. 1990) ("Thus, § 363(m) mootness is not applicable when the Appellant seeks to attack the § 363 sale of estate property on the grounds of improper notice."). See generally 2 Collier on Bankruptcy § 363.13 at 363-43 (15th ed. 1991).

n53 Matter of Edwards, 962 F.2d 641 (7th Cir. 1992). In addition, although not directly on point, the Supreme Court's decision in *Travelers Indem. Co. v. Bailey*, emphasized and relied upon the importance of the finality to be accorded orders of a bankruptcy court in reversing an order of the Court of Appeals for the Second Circuit. 129 S. Ct. 2195 (U.S. 2009). The Second Circuit had allowed a lawsuit to proceed against an insurer despite the insurer's release under the terms of confirmed plan because the Second Circuit ruled that the bankruptcy court did not have the subject matter jurisdiction to enter the order approving the third party release on which the insurer relied. *Id.* at 2203. Without expressly determining the subject matter jurisdiction issue, the Supreme Court held that the bankruptcy injunction barred the claimants' actions and that jurisdiction to issue the injunction was not subject to challenge. *Id.*

n54 *In re Brookfield Clothes, Inc.*, 31 B.R. 978, 982 (S.D.N.Y. 1983); *In re CADA Invs., Inc.*, 664 F.2d 1158, 1160 (9th Cir. 1981) (mootness doctrine inapplicable where parties had conditioned sale on entry of final, non-appealable order).

n55 The extent to which intellectual property licensing rights are assumable or assignable in bankruptcy are beyond the scope of this article but see, e.g., *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9th Cir. 1999).

n56 A buyer should be aware that the assignment of a leasehold interest or contractual right as part of a sale may or may not be entitled to the protections offered a purchaser of assets under section 363(m) of the Code providing for mootness on appeal if a good faith purchaser has relied on an order of the lower court. See, e.g., *In re Stadium Management Corp.*, 895 F.2d 845, 848-49 (1st Cir. 1990) (assignment authorized as part of a sale under section 363 entitled to protection of 363(m)); *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1085 (3d Cir. 1990) (§ 363(m) does not apply to assignment of leases under § 365). But see *In re Delaware and Hudson Railway Co.*, 129 B.R. 388, 394-95 (D. Del. 1991). (Although *Slocum* was binding precedent so as to make § 363(m) inapplicable, consummation of sale to which assignment of contracts was integral, the appeal was rendered moot under general principles of mootness and justiciability).

n57 Even in a non-bankruptcy sale, a break-up fee may be found to be so large as to improperly chill competitive bidding and therefore not to be a proper exercise of the seller's business judgment. See, e.g., *Revlon*,

Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. Supp. 1985). In bankruptcy, there are similar standards but a breakup fee or other buyer protection has often been approved. See, e.g., *In re Bidermann Industries U.S.A., Inc.*, 203 B.R. 547, 552 (Bankr. S.D.N.Y. 1997) ("Three questions need to be considered by the court when it assesses proposals for breakup fees: (1) is the relationship of the parties who negotiated the break-up fee tainted by self-dealing or manipulation; (2) does the fee hamper, rather than encourage, bidding; and (3) is the amount of the fee unreasonable relative to the proposed purchase price?"); *In re Integrated Resources, Inc.*, 135 B.R. 746, 750-51 (Bankr. S.D.N.Y. 1992) and cases cited therein. See also, *In re Adelphia Communications Corp.*, 359 B.R. 65, 87 (Bankr. S.D.N.Y. 2007); *In re Crowthers McCall Pattern, Inc.*, 114 B.R. 877, 879 (Bankr. S.D.N.Y. 1990) (approving a minimum incremental overbid of \$500,000 in a \$45 million sale, a \$2 million deposit by the initial bidder as well as any subsequent bidders, and a \$500,000 break-up fee for the initial bidder); *In re Apex Oil Co.*, 92 B.R. 847 (Bankr. E.D. Mo. 1988) (5% minimum overbid required); *In re A.H. Robins Co.*, No. 85-01307-R, slip op. (E.D. Va. Oct. 22, 1987 and July 7, 1988) (break-up fee of \$25 million, \$50 million or 2.5% of overbid).

n58 *In re Hupp Industries, Inc.*, 140 B.R. 191 (Bankr. N.D. Ohio 1992). See, e.g., *In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999).

n59 *Id.* at 194. See *In re Bidermann Industries U.S.A., Inc.*, 203 B.R. 547, 552 (Bkrcty. S.D.N.Y. 1997).

n60 *In re American West Airlines, Inc.*, 166 B.R. 908 (Bankr. D. Ariz. 1994).

n61 *Id.* at 911.

n62 *Id.* See also *In re CXM, Inc.*, 307 B.R. 94, 103 (Bankr. N.D. Ill. 2004).

n63 See, e.g., *In re Twenver, Inc.*, 127 B.R. 467 (D. Colo. 1991) (order approving "topping fee" (i) is not a final judgment from which there is appeal as of right, (ii) does not qualify as collateral order exception both because fee may never be paid and because the right of appeal from order actually awarding fee provides an adequate remedy, and (iii) since propriety of fees is determined by facts, ruling does not involve controlling issue of law appropriate for interlocutory appeal).

n64 But see *Matter of Edwards*, 962 F.2d 641 (7th Cir. 1992) (lack of notice to lienholder not sufficient grounds to set aside sale on a collateral attack brought 18 months after entry of order approving sale).

n65 See, e.g., *In re Apex Oil Co.*, 92 B.R. 847 (Bankr. E.D. Mo. 1988) (buyer had option to acquire secured debt of \$545 million at a \$150 million discount and would contribute full amount of secured debt as part of purchase price).

n66 See, e.g., *In re Abbotts Dairies of Pennsylvania, Inc.*, 788 F.2d 143 (3d Cir. 1986).

n67 The pending proceedings in *In re Charter Communications.*, provides an unusual setting for a transfer of control. In order to avoid impairing the senior bank lenders and to preserve tax advantages, the plan proposed by the Debtors preserves the principal shareholder's 35% equity interest but implements different voting and control arrangements as amongst the shareholders. Case No. 09-11435 (JMP) (Bankr. S.D.N.Y. 2009).

n68 See *Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 128 S. Ct. 2326, 2332 (U.S. 2008).

n69 Although section 1124 has been in the Code for a while, its provisions are being used more often in the current credit environment where existing financing is on far more favorable terms than those obtainable in the current credit markets and the "unimpairment" of the debt means that the debtor does not need to meet the test of section 1129(b) for a cram down (notably that the plan provide the holder of a secured claim with value equal to the amount of the claim as of the effective date of the plan. *In re Charter Communications*, *supra* note 67. The unimpairment of a class of claims over the objection of the class of creditors means the class does not even have the right to vote on the plan, a treatment currently being discussed in some circles under the nomenclature of a "cram up".

n70 This is the much vaunted "cramdown" section of the Code. The term "cramdown" first appeared in widely in an article published shortly after the enactment of the Bankruptcy Code, Kenneth N. Klee, *A Lending Officer's Primer on the New Bankruptcy Code*, 97 *Banking L.J.* 388, (1980), and is a shorthand reference for the provisions of the Bankruptcy Code that permit a Court to confirm a plan over the objection of an impaired class of creditors and nevertheless bind the creditors in the objecting class to the terms of the plan.

n71 For example, an acquirer may be well advised to include covenants requiring its approval for any transaction outside the ordinary course of business (including pre-approval of any pleadings seeking relief from the bankruptcy court), including restrictions on sales, indebtedness, affiliate transactions and other customary limitations. The prudent acquirer will have a provision requiring that the debtor comply with its obligations under the covenants in both the bidding procedures order with respect to the interim covenants and in the order

ultimately approving the sale.

n72 See, e.g., *Texas Hotel Securities Corp. v. Waco Dev. Co.*, 87 F.2d 395, 398-99 (5th Cir. 1936), cert. denied, 300 U.S. 679 (1937).

n73 Bankruptcy Rule 3001(e) was amended on August 1, 1991 to facilitate the transferability of claims and provide more of a ministerial, rather than a substantive, role for the Bankruptcy Court in connection with such transfers, at least absent special circumstances. See, e.g., *In re Ionosphere Club, Inc.*, 119 B.R. 440, 443-445 (Bankr. S.D.N.Y. 1990) (discussing standards under prior Rule 3001(e) and noting that the then-proposed revision to Rule 3001(e) "takes the bankruptcy court out of the administrative loop by eliminating the need for the court to approve unopposed assignments"). The prudent acquirer will take note, however, of sections 105 and 1126(e) of the Code, which provide a basis upon which the Court may limit the amount of a claim in the hands of a transferee to the amount paid by the transferee or may disqualify a transferee's votes in favor of or against a plan of reorganization if not in "good faith". *In re Allegheny International, Inc.*, 118 B.R. 282, 287-290 (Bankr. W.D. Pa. 1990) (court "designated" or disqualified the votes of prospective acquirer and competing plan proponent rejecting the debtor's plan, finding that the rejection was for an ulterior motive, i.e., to acquire control of the debtor, and in bad faith). *Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims*, 160 F.3d 982 (3d Cir. 1998). Bankruptcy Rule 2019 requires specific and detailed disclosure from jointly represented parties though its provisions historically have been ignored particularly by ad hoc committees who act through lawyers or other representatives but do not restrict themselves from trading activities. This issue has come into increasing focus as bondholders exempt from the requirements of Rule 3001(e) band together to exert collective leverage in bankruptcy cases but do not want to reveal their holdings or trading activities as Rule 2019 requires.

n74 See, e.g., *In re Enron Corp.*, 333 B.R. 205, 229 (Bankr. S.D.N.Y. 2005) (holding that where creditor's inequitable conduct toward the debtor led to equitable subordination of the claim, subsequent transfer to a good faith transferee did not restore the claim's priority); *In re Lorraine Castle Apartments Building Corp.*, 149 F.2d 55 (7th Cir. 1945), cert. denied, 326 U.S. 728 (1945). But see, *In re Chateaugay Corp.*, 109 B.R. 51 (Bankr. S.D.N.Y. 1990) (prepetition exchange of debentures limited to the value of exchange and difference between value and face amount treated as "original issue discount" or unmaturing interest disallowed under section 502(b)(2) of the Code), aff'd sub nom *LTV Corp. v. Valley Fidelity Bank & Trust Co. (In re Chateaugay Corp.)*, 130 B.R. 403 (S.D.N.Y. 1991), rev'd, 961 F.2d 378 (2d Cir. 1992).

n75 There are a number of provisions of the Code that can and do affect the validity, priority or amount of a purchased claim in ways that may or may not affect the claim against the debtor in a non-bankruptcy context. For example, section 502(d) provides, among other things, that a claim shall be disallowed if the claimant is the recipient of a transfer avoidable as a preference or fraudulent transfer; section 507(d) eliminates the priority status for the subrogee of a priority claim; section 510(c) provides for the equitable subordination of claims; and section 553 preserves the debtor's right of setoff for claims against the estate. The foregoing list is not intended to be exclusive, but is offered simply to alert a prospective buyer that there exist substantial and unique risks to

buying claims against a debtor. The discussion in the text focuses on the Code limitations to acquiring control by means of purchasing presumptively valid claims.

n76 The Ninth Circuit distinguished between claims purchased to serve a creditor's "enlightened self interest" and those that had been purchased in "bad faith" and ran the risk of designation under § 1126(e) in *Figter, Ltd. v. Teachers Insurance & Annuity Assoc.*, 118 F.3d 635, 639 (9th Cir. 1997). The *Figter* court noted that "no bad faith is shown when a creditor chooses to benefit his interest as a creditor [through purchasing the claim] as opposed to some unrelated interest . . . [a]nd the mere fact that a creditor has purchased additional claims for the purpose of protecting his own existing claim does not demonstrate bad faith or an ulterior motive." *Id.* At the same time, the court cautioned that situations where (i) "a company, which was not a preexisting creditor, has purchased a claim for the purpose of blocking an action against it"; (ii) "creditors were associated with a competing business and desired to destroy the debtor's business in order to further their own"; or (iii) "the debtor had claims against itself purchased by an insider or affiliate for the purpose of blocking a plan, or fostering one" should be scrutinized by a bankruptcy court. *Id.* Finally, the *Figter* court rejected adopting a rule that, in single asset bankruptcies, claim purchasing activities are *per se* in bad faith. *Id.*

n77 Confirmation by not impairing a class of creditors has become attractive in an environment where loans made during the height of the market are not replaceable at anything like the cost embedded in their terms. Thus, senior secured bank debt from 2006 which may consist of a 5-year revolver at LIBOR plus 1.5% and a 7-year term loan at LIBOR plus 2.5% can be perceived by the borrower as an asset rather than a liability in that the liquidity may be irreplaceable in the current market on any terms and certainly not without paying very substantial additional costs. *See e.g., In re Charter Communications*, Case No. 09-11435 (JMP) (Bankr. S.D.N.Y. 2009); *In re General Growth Properties*, Case No. 09-11977 (Bankr. S.D.N.Y. 2009).

n78 For a primer on what not to do in acquiring claims, the prospective buyer can turn to *Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims*, 160 F.3d 982 (3d Cir. 1998) and *In re Allegheny International, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).

n79 *See, e.g., In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *In re Northwest Airlines Corp.* 363 B.R. 704 (Bankr. S.D.N.Y. 2007); *In re Scotia Development LLC*, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. April 18, 2007). As of the date that this article was completed, these issues regarding required disclosures also were fully briefed, argued and under submission awaiting decision in *In re Washington Mutual Inc.*, Case No. 08-12229 (MFW) (Bankr. Del.).

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Frank Aquila is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. His practice focuses on mergers, acquisitions, strategic alliance and corporate governance matters for large multinational corporations. Mr.

Aquila has been lead outside counsel to companies such as Anheuser-Busch InBev, Amgen, British Airways and Diageo with respect to many of their most significant transactions. Mr. Aquila received a Burton Award for Legal Achievement in 2005 and was named a "Dealmaker of the Year" by the American Lawyer in 2009. He received his A.B. degree from Columbia University and his J.D. degree from Brooklyn Law School.

Hydee Feldstein is a partner in the Sullivan & Cromwell LLP Restructuring and Bankruptcy Group. Ms. Feldstein regularly represents acquirers and other participants in connection with distressed acquisitions, both in and out of bankruptcy court and in the areas of banking, finance, restructuring and bankruptcy. Ms. Feldstein provided insolvency advice to acquirers in a number of key insolvency situations including Lehman Brothers, Washington Mutual and Chrysler. Ms. Feldstein has also advised a number of clients in connection with mezzanine and other CMBS structures and in acquiring or restructuring troubled real estate assets. Ms. Feldstein is regularly ranked as one of the country's leading restructuring and bankruptcy lawyers. She received her B.A. degree from Swarthmore College and her J.D. from Columbia Law School.

The authors thank **Gavin W. Holmes**, an associate of Sullivan & Cromwell LLP for his valuable assistance in the preparation of this article.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



9 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Elleman, Neuhardt, and Hammer on Van Gorkom and Caremark

2009 Emerging Issues 4297

Jennifer N. Elleman, Esq., David A. Neuhardt, Esq., and Christine A. Hammer, Esq. on *Smith v. Van Gorkom* and *In Re Caremark*

By Ms. Jennifer N. Elleman Esq., Mr. David A. Neuhardt Esq. and Ms. Christine A. Hammer Esq.

September 16, 2009

SUMMARY: *Van Gorkom* and *In Re Caremark* are companion cases which explore the duty of care that the board of directors owes to the corporation and its stockholders. *Van Gorkom* deals with the care required in evaluating the merits of a merger and determining whether to recommend it to stockholders. *Caremark*, on the other hand, concerns the duty of care applicable to overseeing more routine decisions made by officers and employees of the corporation.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: **SUMMARY:** *Smith v. Van Gorkom* and *In Re Caremark* are two companion cases which explored the duty of care that the board of directors owes to the corporation and its stockholders. In *Van Gorkom*, the Court explored the duty of a board to be fully informed, finding that in that case that the board did not meet the applicable standard of care in approving a merger. *In Re Caremark* explores the duty of a board to monitor day-to-day operations of the corporation, specifically in connection with violations by the company of federal and state laws. Unlike *Van Gorkom* [cedil] the *Caremark* Board was found to have met its duty of care. This article details the critical distinctions between the actions of the two boards leading to the two different holdings by the Delaware courts.

ARTICLE: The nature of the duty of care owed to a corporation and its stockholders by the board of directors was the subject of much discussion by commentators and the courts in the 1980's and 1990's. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), decided by the Delaware Supreme Court in 1985, dealt with the fiduciary duties of the board of directors of a Delaware corporation, focusing on the duty of care and more specifically on the duty of the directors to be fully informed. At the time, the *Van Gorkom* decision created a great deal of concern about the potential liability of individuals serving as directors of public companies, leading many to speculate that the threat of personal liability would make it impossible for companies to attract and retain qualified board members. As a result of the decision, many states (including Delaware) changed their statutes to limit the personal liability of directors or at least to allow corporations to adopt provisions in their certificates of incorporation limiting the liability of their directors. In addition, the decision undoubtedly led to more careful and deliberate decision-making on the part of directors. Expanding upon the holding in *Van Gorkom* that the Board had not met the burden of showing it had been fully informed of the merits of a proposed merger, *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), focused on the duty of the board of directors to monitor the day-to-day operations of their corporation. Unlike the Delaware Supreme Court in *Van Gorkom*, the Delaware Court of Chancery found in *In Re Caremark* that the directors had

satisfied the applicable standard of care. The remainder of this article contains an in-depth review of the cases and the difference in facts which led to the holdings in these two companion cases.

Van Gorkom. Jerome W. Van Gorkom was the Chairman and CEO of Trans Union Corporation, a publicly-traded, diversified holding company, earning most of its revenue through its railcar leasing business. Although Trans Union generated revenues of hundreds of millions of dollars annually, the company had difficulty generating enough taxable income to claim available income tax credits, and thus was unable to match the prices of its competitors. Trans Union's Board and management team were well aware of this issue and had frequently discussed possible solutions, including an acquisition program or a leveraged buy-out.

On September 13, 1980, without notifying the other members of the Trans Union Board, Van Gorkom held a private meeting with Jay A. Pritzker at which he suggested that Pritzker purchase Trans Union for \$55 per share. The price was based solely on a leveraged buy-out valuation analysis. Over the next several days Pritzker and Van Gorkom, negotiated a deal under which Pritzker would purchase the outstanding shares of Trans Union for \$55 per share and would receive an option to purchase an additional one million shares of treasury stock at \$38 per share, which was \$0.75 above the then current market price. Pritzker insisted that the Trans Union Board act on this proposal by September 21, which was only three days away.

On September 20, Van Gorkom called a meeting of his senior management to be followed by a meeting of the Board of Directors, to present Pritzker's proposal. With only two officers supporting the proposal, management's reaction was almost entirely negative. The Chief Financial Officer (CFO), whose own leveraged buy-out analysis indicated a value of between \$55 and \$65 per share, objected to the price as being too low and also objected to granting Pritzker the option to purchase one million shares. The CFO also expressed concerns about the adverse tax consequences of an all-cash deal for low-basis shareholders. Notwithstanding such objections, Van Gorkom held the special meeting of the Board immediately after his meeting with senior management.

The Trans Union Board was made up of five inside and five outside directors, each of whom had a great deal of business experience. The directors were not informed of the purpose of the meeting prior to the meeting. Although a draft of a merger agreement was provided to the directors, it was delivered too late for a thorough review either before or during the meeting. Van Gorkom informed the Board that, under the terms of Pritzker's offer, Trans Union was free to receive competing offers for a period of 90 days, but was prohibited from actively soliciting suitors or providing any proprietary information to competing bidders. James Brennan, an attorney retained by Van Gorkom and present at the meeting, advised the Board that a fairness opinion was not required as a matter of law and that they could be sued if they did not accept Pritzker's offer. The CFO informed the Board that his valuation analysis, which had been prepared for the purpose of determining a suitable price for a leveraged buy-out, did not directly address the fairness issue and that he had been unaware of the merger proposal until earlier that morning. He also advised directors that while \$55 was "in the range of a fair price," it was at the "beginning of the range." Following the oral presentations and a discussion which totaled only about two hours, the directors approved the merger. Although the minutes of the meeting made no mention of any conditions upon the Board's acceptance, directors later claimed to have conditioned their acceptance upon Trans Union's right to accept any better offer made during the 90-day market test period and to share proprietary information with any potential bidder. Van Gorkom executed the merger agreement later that evening while attending the opera, but never actually read the agreement prior to its execution.

Following a press release announcing that Trans Union had entered into a "definitive" merger agreement with an affiliate of the Marmon Group, Inc., a Pritzker holding company, many members of Trans Union's senior management team threatened to resign. In response, Van Gorkom negotiated amendments to the merger agreement intended to permit Trans Union's investment banker to solicit other offers for the Company during the proposed "market test" period. On October 8, Van Gorkom reconvened the Board to approve the proposed amendments without having seen or reviewed the actual documents. Although the final amendments, when they later came, constrained Trans Union's ability to negotiate other offers and withdraw from the agreement with Pritzker, Van Gorkom executed them without reconvening the Board to consider the changes.

Two other suitors approached Trans Union during the 90-day "market test" period. General Electric Credit Corporation subsequently terminated further discussions with Trans Union after it refused to rescind its merger agreement with Pritzker, and Kohlberg, Kravis, Roberts & Co. withdrew an offer, allegedly due to Van Gorkom's influence over Trans Union management.

On December 19, a class action suit was brought on behalf of Trans Union's stockholders against the directors. The Trans Union Board met again on January 26 and voted to proceed with the Pritzker merger. On February 10, the Trans Union stockholders approved the Pritzker merger proposal by large majority.

The Court of Chancery found that the Trans Union Board had acted in an informed manner in approving the merger with Pritzker (and was, therefore, entitled to the protection of the business judgment rule) and that the stockholders had been "fairly informed" by the Board prior to their vote. The plaintiffs appealed to the Delaware Supreme Court, which reversed the Chancery Court's decision.

As developed by the Delaware courts, the business judgment rule is a "presumption that in making a business decision the directors of a corporation acted in good faith and in the honest belief that the action taken was in the best interests of the company." n1 If the plaintiff cannot offer sufficient evidence to rebut this presumption, a court will not question the board decision even if the court disagrees with the merits of the decision. The Delaware courts have also found that, in making a business decision, the directors of a Delaware corporation owe a duty of care to the corporation and thus have a responsibility to exercise informed business judgment by informing themselves of "all material information reasonably available to them" prior to making business decisions. n2 Delaware courts have applied a gross negligence standard in determining whether a business judgment was "informed."

The Trans Union directors made the following arguments to support application of the business judgment rule to their decision to approve the merger: (1) they relied in good faith on reports made by officers and outside experts, including Mr. Brennan's advice that they might be sued for rejecting Pritzker's offer; (2) Pritzker's offer of \$55 per share represented a significant premium over Trans Union's market price of the proposed \$38 per share at the time; (3) the "market test" period gave the Board the opportunity to seek higher offers; and (4) the directors were well qualified to approve the merger because they had years of experience and a substantial amount of business expertise. n3 The directors further argued that the Court should consider not only their knowledge of the deal at the September 20 meeting at which they first voted to approve the merger, but should also consider everything they subsequently learned over the next few months prior to the shareholder vote in February. n4

Although Section 141(e) of the Delaware General Corporation Law provides that directors may rely in good faith on the reports of officers, the *Van Gorkom* Court found that the oral presentations given by Van Gorkom and Trans Union's CFO at the September 20 meeting did not qualify as "reports" for this purpose because they were not pertinent or informed and therefore were not entitled to good faith reliance. n5 Van Gorkom had not himself reviewed the merger agreement about which he was presenting and the CFO's analysis, admittedly, was not relevant to a cash-out merger scenario. The Court noted that the directors did not make a proper inquiry concerning either presentation and further that no supporting documentation was provided. The Court completely dismissed the argument relating to Mr. Brennan's statement that a rejection of Pritzker's offer might lead to a lawsuit, stating "we can not conclude that the mere threat of litigation, acknowledged by counsel, constitutes either legal advice or any valid basis upon which to pursue an uninformed course." n6

The Delaware Supreme Court acknowledged that a substantial premium may be one reason to recommend a merger, but stated that the adequacy of a premium must be analyzed in light of appropriate valuation information. The Trans Union Board never requested an outside valuation study or even a review by Trans Union's CFO of the fairness of the proposal. Rather, the directors simply accepted the CFO's brief presentation stating that the \$55 per share price was "in the range of a fair price" without making further inquiry of the CFO or requesting any documentation related to his study. The Board had no other information to consider in evaluating the premium other than the current market price, which represented only the value of a minority position in the company and which, as the directors were well aware,

had been depressed historically.

The directors argued that the "market test" conducted after the merger agreement was signed confirmed the reasonableness of their decision to approve the merger and eliminated the need for any further tests as to the fairness of Pritzker's proposal. The Court disagreed, stating that there was no evidence that a public auction took place or that an auction was even permitted under the amendments to the merger agreement. The Court stated "the record compels the conclusion that the directors had no rational basis for expecting that a market test was attainable, given the terms of the Merger Agreement as executed during the evening of September 20." n7

The directors argued that their collective experience and business expertise supported their position that their decision was informed and reasonably deliberated. The Court dismissed this claim quickly, however, by comparing their situation to that of the Board of Directors in *Gimbel v. Signal Companies, Inc.*, a case decided by the Delaware Court of Chancery and affirmed by the Delaware Supreme Court in 1974. The *Signal* Court had enjoined a sale of stock "for failure of management to give its board 'the opportunity to make a reasonable and reasoned decision.'" n8 Like the *Van Gorkom* Board, the *Signal* Board was experienced and sophisticated and was asked to make a quick decision, but the *Signal* Court found such factors to be "outweighed by evidence of gross negligence." n9

The *Van Gorkom* Court concluded that the Trans Union Board's decision to approve Pritzker's offer on September 20 was not informed and, given all of the circumstances, was "at a minimum" grossly negligent. n10 As for the directors' argument that the Court should consider their subsequent actions following the September 20 meeting, the Court found that the subsequent actions, being equally uninformed, were not sufficient to cure the Board's prior misconduct. For example, during the October 8 meeting, the Board had approved the amendments to the merger agreement "sight unseen" and gave Van Gorkom the authority to execute the final amendments upon receipt, which did not occur until two days later. The amendments also did not, in fact, allow a market check on the terms the Trans Union Board claimed it had insisted upon; rather the amendments allowed Trans Union to withdraw only if it entered into a "definitive" merger agreement with another party for a higher price or consummated a merger with another party prior to February 10, 1981. The Court found that "confirmation of the appropriateness of the Pritzker offer by an unfettered or free market test was virtually meaningless in the face of the terms and the time limitations of Trans Union's merger agreement with Pritzker as amended October 10, 1980." n11 The directors also argued that they were still free to reject Pritzker's offer at their last meeting on January 26, at which they claimed they had conducted a more thorough review of all relevant facts; however, the Court found that the Board was not free at that time to withdraw from the merger with Pritzker, and, in any event, still lacked important information as to the value of the Company.

Lastly, the directors argued that their approval of the transaction was ratified by the stockholder approval of the merger on February 10. The Court disagreed, even though a large majority of stockholders had voted in favor of the merger, because it found that the stockholders were not fully informed. The stockholders had not been provided any information regarding the value of the Company other than the depressed market price, and the proxy materials had not disclosed the Board's lack of information. Additionally, the Court found that the details provided in the proxy statement concerning the CFO's report to the Board regarding valuation were "false and misleading." Although supplemental proxy material had contained new and important information concerning the Board's lack of inquiry and deliberation, the Court found that the information had not met the disclosure standard under *Lynch v. Vickers*, a case decided by the Delaware Supreme Court in 1978, which held "that corporate directors owe to their stockholders a fiduciary duty to disclose all facts germane to the transaction at issue in an atmosphere of complete candor." n12 Ultimately the Court found that the directors had the burden of proving that the stockholders were fully informed and had not met this burden.

Caremark. Stockholders of Caremark filed several derivative suits against the Company's directors in 1994 in an attempt to recover damages for substantial corporate losses resulting from alleged violations of federal and state laws regarding payments to health care providers by Caremark employees.

Following an extensive investigation by the federal government, Caremark was indicted by a federal grand jury for

violating the Anti-Referral Payments Law, which prohibits health care businesses from paying providers for referrals of Medicare and Medicaid patients. Caremark had long engaged in the questionable practice of entering into contracts for services such as consulting agreements and research grants with certain physicians who recommended or prescribed Caremark products or services to Medicare patients. Caremark was able to negotiate a settlement agreement with federal and state government entities under which it was allowed to continue participating in Medicare and Medicaid programs in exchange for a guilty plea to mail fraud and payment of substantial criminal fines and civil damages in excess of \$150 million. Additionally, Caremark negotiated a nearly \$100 million settlement with several private insurance companies which had claimed damages as a result of Caremark's "improper business practices." None of the senior officers or directors of Caremark were charged with any wrongdoing in the indictment or settlements.

The derivative suits against the Caremark Board were consolidated into one action and the directors entered into settlement negotiations with the parties in May 1995. The terms of the proposed settlement required that Caremark undertake seven compliance related actions to assure that Caremark complied with applicable laws in the future. Although initially, the plaintiffs also requested monetary penalties, the final proposed settlement did not require the directors to pay any fines or damages.

The Court of Chancery reviewed the proposed settlement of the derivative action to determine if it was fair and reasonable. In rendering its opinion, the *Caremark* Court distinguished two different contexts under which director liability for a breach of the duty to exercise "due attention" might arise. Under the first class of cases, director liability may arise from an ill advised or "negligent" board decision resulting in loss. The *Caremark* Court stated that this "first class of cases will typically be subject to review under the director-protective business judgment rule, assuming the decision made was the product of a process that was either deliberately considered in good faith or was otherwise rational." n13 The *Van Gorkom* case fits in this class of cases; while *Van Gorkom* did not emphasize the concept of "good faith," the *Caremark* analysis is consistent with the declarations in *Van Gorkom* that the Trans Union Board had breached its duty of care because the directors were so ill informed that their conduct amounted to gross negligence. It is difficult to argue that a director who was grossly negligent was acting rationally or in good faith. The *Caremark* Court expanded this concept further by holding that "[w]here a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to fully satisfy the duty of attention." n14

Under the second class of cases identified in *Caremark*, a director may be liable based on an "unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." n15 *Caremark* fit into this second class of cases. The stockholders made no claim that the Caremark Board was aware of the questionable practices of certain Caremark employees that resulted in liability; rather, the stockholders asserted that the directors "ought to have known" about these practices. In its opinion, the *Caremark* Court acknowledged that corporate boards "will be required only to authorize the most significant corporate acts or transactions", but that "ordinary business decisions that are made by officers and employees deeper in the interior of the organization can, however, vitally affect the welfare of the corporation and its various strategic and financial goals." n16 Thus, while the *Van Gorkom* case concerned the duty of the board to be fully informed when making decisions on behalf of the corporation, *Caremark* considered the duty of the board's duty to inform itself of decisions made by officers and other employees that might result in corporate loss.

The *Caremark* Court likened the *Caremark* facts to those in *Graham v. Allis-Chalmers Mfg. Co.*, a 1963 Delaware Supreme Court case concerning director liability for violations of anti-trust laws. In *Graham*, as in *Caremark*, the plaintiffs asserted that the directors "ought to have known" of the anti-trust law violations and would have had a duty to bring the corporation into compliance with the law if they had known. The *Graham* Court found that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." n17 The *Caremark* Court found that *Graham* supported the proposition that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf", but that proposition should not be expanded to release a board of its responsibility to assure appropriate information and reporting systems n18 The *Caremark* Court acknowledged that no reporting system could eliminate all risk for legal

noncompliance and that the question of the level of detail necessary under any such system is a question of business judgment. Thus, the *Caremark* Court concluded that the directors had a duty to "attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards." n19

The Caremark Board already had a committee in place to monitor corporate compliance. In fact, Caremark's predecessor, Baxter International, Inc., had a policy in place regarding contractual relationships as early as 1989, which was regularly reviewed by lawyers and updated annually. The Caremark Board took various steps to educate employees on compliance matters and assure that all contracts with, and disbursements to, physicians were approved by regional officers and local management. Although Caremark acknowledged that its interpretation of the law was "uncertain", it appears that the Company's contract forms had been approved by counsel.

The Court held that the proposed *Caremark* settlement was fair and reasonable even though it did not require any significant payments on the part of the directors. The *Caremark* Court stated that the level of participation by the directors seemed adequate given the lack of evidentiary support for the stockholders' claims n20 According to the Court, the stockholders had not shown that the Caremark Board breached its duty of care because the record did not support a finding that the directors knew or should have known about the violations of law or that the directors failed to make a good faith effort to prevent or correct the situation.

The *Caremark* Court found that the Caremark Board, which had relied on the reports of experts finding that the Company's practices, even though contestable, were within applicable law, did not knowingly violate any statute. The stockholders did not provide any evidence that such reliance was unreasonable. Although the Board may not have been aware of all of the details that surfaced under the indictments, the Court stated that "the duty to act in good faith to be informed cannot be thought to require directors to possess detailed information about all aspects of the operation of the enterprise." n21 The *Caremark* Court further found that, even though the Caremark Board was not aware of all of the details leading to the corporate loss, the Board did not breach its duty to monitor corporate activity. Caremark had information systems in place to monitor corporate compliance. The Court found that these measures represented a good faith effort on the part of the Caremark Board to remain informed; therefore, the Board could not be faulted for the fact that it was unaware of all relevant activity. n22 According to the Court, "only a sustained or systematic failure of a board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system existed will establish the lack of good faith that is a necessary condition of liability." n23

At first glance the decision in *Caremark* may appear to be inconsistent with the strict standard of care applied in *Van Gorkom*, but the decisions can be reconciled based on their very different fact patterns. Both cases concern the duty of care owed by the directors of a corporation to the corporation's stockholders; however, the cases fall into two different categories. *Van Gorkom* dealt with the care required in evaluating the merits of a merger and determining whether to recommend the merger to the stockholders. The merger was a major corporate transaction that had to be authorized by the board of directors and was completely within the board's control. *Caremark*, on the other hand, concerned a Board's duty of care applicable to overseeing more routine decisions made by officers and employees of the corporation. Decisions of this nature are generally not within the board's control. Although a board may and should set policies and review reports regarding compliance with its policies, the board may not always have knowledge of every decision made or every detail regarding every particular contract to which the corporation is a party. As the *Caremark* Court stated, "Such a requirement would simply be inconsistent with the scale and scope of efficient organization size in this technological age." n24 The directors owe a duty to their corporation and stockholders to make a good faith effort to act in the best interests of the corporation. The *Van Gorkom* Board, which was not even aware of Trans Union's true value or familiar with the terms of the merger agreement which they had approved, can not be said to have acted in good faith. On the other hand, although the *Caremark* Board's attempts to monitor compliance with the law were not fully successful and its interpretation of the law proved to be incorrect, the Board had acted in good faith. Directors are not required to make the correct decision every time so long as their decisions are well informed and rational. An interpretation requiring anything more would, as critiques feared following the decision in *Van Gorkom*, prevent

corporations from attracting talented and qualified directors.

ADDITIONAL RESOURCES:

For more on target board's fiduciary duties, see M&A Practice Guide, Chapter 3, "Corporate Law Issues"

For more on officer and director liability, see Liability of Corporate Officers and Directors, Chapter 3, "Duty of Diligence" and Chapter 14, "Liability in Takeovers, Mergers and Buyouts"

See also, Delaware Corporation Law and Practice, Chapter 15, "The Proper Exercise of Directors' Responsibilities"

Return to Text

n1 *Van Gorkam*, 488 A.2d 858, 872 (1985).

n2 *Van Gorkam*, 488 A.2d 858, 873 (1985).

n3 *Van Gorkam*, 488 A.2d 858, 875 (1985).

n4 *Van Gorkam*, 488 A.2d 858, 874 (1985).

n5 *Van Gorkam*, 488 A.2d 858, 875 (1985).

n6 *Van Gorkam*, 488 A.2d 858, 881 (1985).

n7 *Van Gorkam*, 488 A.2d 858, 878 (1985).

n8 *Van Gorkam*, 488 A.2d 858, 880 (1985).

n9 *Van Gorkam*, 488 A.2d 858, 880 (1985).

n10 *Van Gorkam*, 488 A.2d 858, 874 (1985).

n11 *Van Gorkam*, 488 A.2d 858, 885 (1985).

n12 *Van Gorkam*, 488 A.2d 858, 890, 892-893 (1985).

n13 *In Re Caremark*, 698 A.2d 959, 967 (Del. Ch. 1996)

n14 *In Re Caremark*, 698 A.2d 959, 967 (Del. Ch. 1996)

n15 *In Re Caremark*, 698 A.2d 959, 967 (Del. Ch. 1996)

n16 *In Re Caremark*, 698 A.2d 959, 968 (Del. Ch. 1996)

n17 *In Re Caremark*, 698 A.2d 959, 968 (Del. Ch. 1996)

n18 *In Re Caremark*, 698 A.2d 959, 969 (Del. Ch. 1996)

n19 *In Re Caremark*, 698 A.2d 959, 970 (Del. Ch. 1996)

n20 *In Re Caremark*, 698 A.2d 959, 971 (Del. Ch. 1996)

n21 *In Re Caremark*, 698 A.2d 959, 971 (Del. Ch. 1996)

n22 *In Re Caremark*, 698 A.2d 959, 972 (Del. Ch. 1996)

n23 *In Re Caremark*, 698 A.2d 959, 971 (Del. Ch. 1996)

n24 *In Re Caremark*, 698 A.2d 959, 971 (Del. Ch. 1996)

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Jennifer N. Elleman is Director and Senior Corporate Counsel for LexisNexis, a division of Reed Elsevier Inc. She is responsible for all aspects of customer contracting including drafting and negotiating customer agreements for LexisNexis customers in both the public and private sector including federal, state, and local government, corporate, law firm, and academic markets. Prior to joining LexisNexis, Ms. Elleman practiced in the Corporate Transactions (M&A) and Securities department of the Dayton, Ohio office of Thompson Hine LLP. At Thompson Hine, Ms. Elleman represented numerous public and private companies on a wide range of commercial matters including M&A, private placement of securities, securities offerings, corporate organization and governance.

David A. Neuhardt is a partner in the Corporate Transactions and Securities practice group of Thompson Hine LLP in the Dayton office. He focuses his practice on acquisitions and divestitures, securities law compliance, corporate finance, corporate governance and joint ventures and strategic alliances. Mr. Neuhardt has represented clients in a wide range of industries, including paper, equipment manufacturing, construction products, and energy and information solutions. He received an AV rating from Martindale-Hubbell and has been recognized as a Best Lawyer in American for more than 10 years and an Ohio Super Lawyer by Ohio Super Lawyer Magazine.

Christine A. Hammer is an associate in the Corporate Transaction and Securities practice group of Thompson Hine LLP in the Dayton office. She focuses her practice on acquisitions and divestitures, securities offerings, corporate organization and governance and joint ventures. Prior to attending law school, Ms. Hammer worked as a software engineer.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



10 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Santel, Bassett and Miles on Texaco and Binding Intent Letters

2009 Emerging Issues 4085

Patrick Santel, Liz Bassett and Rachel A. Miles on Texaco, Inc. v. Pennzoil, Co.: When Letters of Intent Are Binding and Drafting Guidance

By Mr. Patrick Santel Esq., Ms. Liz Bassett Esq. and Ms. Rachel A. Miles Esq.

July 29, 2009

SUMMARY: Letters of intent may give rise to unintended legal consequences, such as being bound when parties did not intend to be so bound or third parties may be liable for tortious interference. The *Texaco v. Pennzoil* case forced boards of directors and legal practitioners to reexamine how they view letters of intent and provides guidance as to steps parties can take to reach the desired results when drafting them.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: *Texaco, Inc. v. Pennzoil, Co.*, 729 S.W.2d 768 (Tex. App. 1987), cert. dismissed, 485 U.S. 994 (1988).

Parties use letters of intent in M&A transactions for various reasons. For example, a letter of intent can be useful to guide parties' expectations as to certain terms of a potential transaction, to "test the waters" before incurring the costs of negotiation and investigation of a transaction, or to help the buyer secure financing for a transaction. Also, signing a letter of intent allows parties to file a premerger notification report under the Hart-Scott-Rodino Antitrust Improvement Act of 1976, which will start the clock running on the waiting period. Letters of intent, however, may give rise to certain legal consequences. For example, a party may find itself bound by the letter of intent, or a term therein, when that party did not intend to be bound until the execution of the final definitive written agreement. Therefore, that party may not be able to walk away from the transaction, or term, without becoming vulnerable to a claim for breach of contract. Along the same line, the letter of intent can expose third parties to the risk of claims such as tortious interference with a contract if the letter of intent was found to bind the original parties to an agreement.

A striking illustration of the risk that letters of intent pose to third parties is found in *Texaco, Inc. v. Pennzoil, Co.* On November 19, 1985, a jury awarded Pennzoil, Co. ("Pennzoil") \$ 10.53 billion, consisting of \$ 7.53 billion in compensatory damages and \$ 3 billion in punitive damages, on its claim that Texaco had tortiously interfered with a contract between Pennzoil and the Getty Oil Company ("Getty Oil"), the Sarah C. Getty Trust (the "Trust"), and the J. Paul Getty Museum (the "Museum") (collectively the "Getty Entities").

The events forming the basis of Pennzoil's claim began on December 28, 1983, when Pennzoil made an unsolicited public tender offer at \$ 100 per share for 16 million shares of Getty Oil. Pennzoil then began discussions with Gordon Getty, a director of Getty Oil and trustee for the Trust which owned 40.2% of Getty Oil's outstanding shares, and a

representative of the Museum, which owned 11.8% of Getty Oil's outstanding shares. In early January 1984, Pennzoil, the Trust, and the Museum drafted a document entitled "Memorandum of Agreement" to reflect terms which had been reached during their discussions. The Memorandum of Agreement contained a number of points regarding the parties' plan, including:

- Pennzoil and the Trust would become partners in owning and operating Getty Oil--Pennzoil would be a 3/7ths owner, with its CEO becoming CEO of the "new company," and the Trust would be a 4/7ths owner, with Gordon Getty as the trustee of the Trust and chairman of the board of the "new company."
- All other outstanding stock of Getty Oil, including the Museum's shares, would be cashed in at \$ 110.
- Pennzoil and the Trust would make a good faith attempt to agree on a plan to restructure Getty Oil within one year. If an agreement was not reached, Pennzoil and the Trust would divide Getty Oil's assets according to their respective share in Getty Oil.
- The Memorandum of Agreement was subject to the approval of Getty Oil's board (the "Getty Board") and would expire by its own terms if not approved at the Getty Board meeting set to begin on January 2, 1984.

Before the Getty Board meeting on January 2nd ("January 2nd Meeting"), both Pennzoil and the Trust signed the Memorandum of Agreement. The Museum signed the Memorandum of Agreement shortly after the Getty Board meeting began, though before the Memorandum of Agreement was submitted to the Getty Board for approval.

At the January 2nd Meeting, the Getty Board reviewed the Memorandum of Agreement and voted to reject both the motion to recommend Pennzoil's tender offer to the shareholders and the price of \$ 110 in the Memorandum of Agreement. The Getty Board decided to make a counter-proposal to Pennzoil of a purchase price of \$ 110 per share plus a \$ 10 debenture. Pennzoil's investment banker reacted "negatively" to this proposal.

The next morning, Getty Oil's investment banker, Geoffrey Boisi, contacted other potential purchasers to see if he could obtain a higher bid. When the Getty Board reconvened that afternoon ("January 3rd Meeting"), Boisi reported that there had been other "preliminary indications of interests," though nothing definite. The Getty Board reviewed a revised offer from Pennzoil at \$ 110 per share plus a \$ 3 stub that would be paid to the shareholders after the sale of Getty Oil's subsidiary from the sale proceeds that exceeded \$ 1 billion. By a vote of 15 to 1, the Getty Board approved making a counter-offer to Pennzoil at \$ 110 per share plus a \$ 5 stub. Following the counter-offer vote, the Getty Board then voted to indemnify Getty Oil's directors and officers for liability arising from events of recent months and to authorize golden parachutes for top executives whose positions might be impacted by the management change. Before the January 3rd Meeting was adjourned, Pennzoil accepted the counter-offer, and its acceptance was communicated to the Getty Board.

On January 4, 1984, Pennzoil and the Getty Entities issued separate, yet identical, press releases "announcing an agreement in principle on the terms of the Memorandum of Agreement but with a price of \$ 110 plus a \$ 5 stub." The press releases also stated that "[t]he transaction is subject to execution of a definitive merger agreement." Pennzoil attorneys immediately began working on a draft of the transaction agreement.

Meanwhile, Boisi continued his efforts to seek a higher bid, and reached out to Texaco, among other potential purchasers. After speaking with Boisi, Texaco immediately hired an investment banker and began to study the prospect of acquiring Getty Oil. On January 5, 1984, the *Wall Street Journal* published a report on the agreement between Pennzoil and the Getty Entities. On that same day, Texaco's board authorized making an offer for 100% of Getty Oil and Texaco's lawyer contacted the Getty Entities to request meetings with the representative of the Museum and with Gordon Getty as a representative of the Trust. After negotiations between Texaco and the Getty Entities, the Museum and the Trust agreed to sell their shares to Texaco for \$ 125 per share. The next day, the Getty Board voted unanimously to accept Texaco's offer and withdraw its previous counter-offer to Pennzoil. Texaco then issued a press release which announced the merger of Texaco and Getty Oil. After the press release was issued, Pennzoil contacted the Getty Entities and requested that they abide by the agreement previously put into place with Pennzoil. In response, Getty Oil filed suit

in Delaware for a declaratory judgment that it was not bound by an agreement with Pennzoil.

Pennzoil filed suit against Texaco in a Texas District Court alleging that Texaco had tortiously interfered with Pennzoil's agreement with the Getty Entities. To analyze this claim, the jury had to determine whether Pennzoil and the Getty Entities had intended to be bound by an agreement that had been reached before Texaco made its offer to purchase Getty Oil. The jury sided with Pennzoil finding that Pennzoil and the Getty Entities had reached a binding agreement as of the end of the January 3rd Meeting. Additionally, the jury found that Texaco had "knowingly interfered" with the Getty/Pennzoil agreement and that Texaco's acts of interference were "intentional, willful and in wanton disregard of Pennzoil's rights." Lastly, the jury found that due to Texaco's acts, Pennzoil was entitled to damages of \$ 7.53 billion and an additional \$ 3 billion in punitive damages.

Texaco appealed the case to the First District of the Texas Court of Appeals. For the appeal, Texaco raised several arguments of appeal against the jury's findings, including whether the evidence was sufficient to show that Pennzoil and the Getty Entities had an agreement and that Texaco had intentionally induced a breach of such. Based on its review of the case, the Texas Court of Appeals affirmed the jury award in favor of Pennzoil, though reduced the award of punitive damages from \$ 3 billion to \$ 1 billion.

First, Texaco argued that there was insufficient evidence (both legally and factually) to show that Pennzoil and the Getty Entities had intended to bind themselves to an agreement as of the end of the January 3rd Meeting and that Texaco had knowingly tried to interfere with this agreement. Applying New York law, the court stated that the "emphasis in deciding when a binding contract exists is on [the] intent [of the parties to the contract] rather than on [the] form [of the contract];" thus, parties may be bound to an agreement even in the absence of a formal signed document which memorializes that agreement. The court continued to opine that in making the determination of whether the parties intended to be bound before the signing of a formal agreement, the jury may only consider express manifestations of intent. The factors the jury could use to help it resolve the issue of the parties' intent were:

(1) whether a party expressly reserved the right to be bound only when a written agreement is signed; (2) whether there was any partial performance by one party that the party disclaiming the contract accepted; (3) whether all essential terms of the alleged contract had been agreed upon; and (4) whether the complexity or magnitude of the transaction was such that a formal, executed writing would normally be expected.

The court used this four-factor framework to evaluate Texaco's arguments that the evidence was insufficient to support the jury's findings.

Under the first factor, Texaco pointed to the use of the language "subject to" and "agreement in principle" in Pennzoil's and the Getty Entities' press releases as evidence that the parties did not believe they had a binding agreement. The court recognized the use of "subject to" as conditional language. However, it pointed to the press releases' consistent use of the indicative term "will" when describing the plan (i.e., "each shareholder will receive" and "Pennzoil will contribute") and concluded that the press releases "did not so clearly express the intent of the parties not to be bound to conclusively resolve the issue." Additionally, the court emphasized that evidence presented during the trial on common usage of "agreement in principle" was such that the jury could make a reasonable determination that the parties intended to be bound by the document.

As to the second factor, partial performance, Texaco argued that the parties had not partially performed and, in fact, had taken actions which were "inconsistent with the existence of a binding contract," such as Getty Oil's investment advisor, Boisi, seeking other bids from parties including Texaco. Though the court agreed that there was little "relevant partial performance" with the exception of Pennzoil's financial preparations, it concluded that limited partial performance in a short period of time (a couple of days in the facts at hand) was not sufficient alone to force a jury to decide that there was no contract between the Getty Entities and Pennzoil.

Texaco set forth a number of arguments under the third factor, whether all of the critical terms of the agreement

had been determined, arguing that several terms were still being negotiated by the parties. The court acknowledged that Texaco and Pennzoil had presented conflicting evidence at trial as to whether certain issues were resolved, including as to whether the Getty Board's approval of a counter-offer of \$ 110 per share plus a \$ 5 stub represented acceptance of the Memorandum of Agreement with a different price term or that further negotiation would be required. However, the court pointed to the fact that Pennzoil, the Trust, and the Museum all signed the Memorandum of Agreement before it was put before the Getty Board and the document resolved certain of these issues. Based on these facts, the court determined that the evidence was sufficient for a jury to have concluded that any open issues that remained were not "significant obstacles precluding an intent to be bound" to an agreement.

As to the final factor which is whether a transaction is so complex that one would expect it to be documented in a signed formal written document, the court agreed with Texaco that the size and complexity of the transaction would tend to indicate that the parties did not intend to be bound until the execution of a formal agreement. However, the court observed that this one factor was not, as a matter of law, dispositive on the question of intent. Thus, evaluating the evidence presented under this four factor framework, the court found the evidence presented to the jury had been legally and factually sufficient to support the jury's findings that the parties intended to be bound to an agreement as of the end of the January 3rd Meeting.

In addition to the foregoing, Texaco made further attempts to persuade the court to overturn the jury's findings. First, it argued that even if the parties had intended to create a binding document with the Memorandum of Agreement, the parties failed to do so since the document was vague. New York law requires that the terms of a contract be "ascertainable to a reasonable degree of certainty" in order for such contract to be enforceable. Texaco argued that the Memorandum of Agreement failed to describe certain essential terms, including how the purchase price would be paid in the transaction, how the ratio for stock ownership would be met or how tax penalties would be covered. The court called Texaco's argument "unpersuasive" finding that Texaco was trying to make up new essential terms based on the terms set forth in the Memorandum of Agreement. The court concluded that the evidence was sufficient to support the jury's finding that a binding agreement was in place.

Next, Texaco argued that there was no evidence to support the jury's finding that Texaco did have knowledge of the agreement between the Getty Entities and Pennzoil. Texaco emphasized that even though it was aware of the Memorandum of Agreement, it was not aware of what decisions had been made by the Getty Board at its meeting and that it had received several oral assurances from Getty Oil's investment advisor, Texaco's own investment banker, and Getty's CEO that no agreement was in place with Pennzoil. Texaco concluded that there was no direct evidence to support the jury's finding that it did have knowledge of the agreement. New York law provides that when there is not sufficient direct evidence for a finding of knowledge, the court must look at whether circumstantial evidence was sufficient for a jury to infer knowledge. Looking at the circumstantial evidence presented during the trial, the court rejected Texaco's argument holding that the jury could have inferred knowledge based on (i) Texaco's intense study of the Pennzoil plan and notes from Texaco's executives indicating that it had to "stop the [Pennzoil] train", reasoning if Texaco did not have knowledge of an agreement, it would not have felt an urgency to act so quickly; and (ii) a *Wall Street Journal* article published the day after the press release was issued which reported on the agreement between the Getty Entities and Pennzoil more than 15 times based on unconvincing testimony from one Texaco executive that he could not recall if he had seen the article and testimony from Boisi that another Texaco executive "may have" referenced the article on a call.

In addition, Texaco argued that there was insufficient evidence for the jury to conclude that Texaco had purposefully acted to induce the Getty Entities to breach the Pennzoil/Getty agreement. Texaco argued that Getty Oil's investment advisor reached out to Texaco and asked it to make a bid. It simply responded to this request. The court refused to accept this argument finding that Texaco had acted in a calculated fashion in working its strategy to acquire Getty Oil, evidenced by how quickly it acted to acquire the company, and notes from Texaco executives that indicated that Texaco must "stop the train."

By rejecting Texaco's various arguments with respect to a lack of sufficient evidence to support the jury's findings,

the court affirmed the jury's decision in *Texaco v. Pennzoil*. The decision in this case forced boards of directors and legal practitioners nationwide to reexamine how they view letters of intent. Although some argue that *Texaco v. Pennzoil* was wrongly decided, the case provides guidance as to steps parties can take when drafting a letter of intent. These drafting techniques have become common practice amongst attorneys when preparing letters of intent. First, parties should consider including language which indicates which items in the letter of intent are binding and which are not. If the letter of intent is ever examined in a court case, as was the Memorandum of Agreement in *Texaco v. Pennzoil*, this language may prevent the court from having to look at extrinsic evidence to determine whether the document was intended to be binding. In addition, for clarity's sake, the parties should consider separating the binding provisions of the letter of intent from the non-binding provisions to avoid any unnecessary confusion. Second, as seen with the press release in *Texaco v. Pennzoil*, parties should avoid using both conditional language and indicative terms. Instead, the parties should focus on only using conditional language if the parties do not intend for the letter of intent to be binding in order to emphasize that the agreement is not final, such as referring to the transaction as "preliminary" or a "possibility". Third, if the parties intend for the letter of intent to be non-binding, they should avoid requiring performance by a party. Such a requirement will make the letter of intent look more like it was intended to be a binding agreement and may confuse a court. Lastly, if the parties intend for the letter of intent to be non-binding, then the parties should leave key issues unresolved to show that the negotiations are on-going. As emphasized in *Texaco v. Pennzoil*, the more detail included in the letter of intent, the more likely the court will find that essential terms were agreed upon and a binding agreement was put into place. As learned by the parties in *Texaco v. Pennzoil*, a letter of intent should be entered into and drafted cautiously to avoid unexpected consequences for the direct parties involved or any third parties related to the potential transaction. Acknowledging that risk and drafting the letter of intent accordingly, a corporation can use a letter of intent as a helpful first step in negotiations for a successful transaction.

ADDITIONAL INFORMATION:

Chapter 5, "Preliminary Agreements" in the M&A Practice Guide (LexisNexis).

Chapter 14, "The Initial Underwritten First Offering" in Securities Law Techniques (LexisNexis).

Chapter 1, "The Business Setting of Corporate Acquisitions" in Corporate Acquisitions and Mergers (LexisNexis).

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Patrick Santel is Corporate Counsel at LexisNexis, a division of Reed Elsevier Inc. in the Outsourcing and Technology Contracting Group. He is based in Bellevue, Washington. Mr. Santel's practice focuses on (i) outsourcing contracts (ii) commercial and technology contracting matters and (iii) non-disclosure agreements ("NDA"s). Before joining LexisNexis, he was a corporate attorney for a business enterprise software company where he provided legal guidance and services, including drafting and negotiating technology licensing contracts, services agreements, consulting agreements and NDAs.

Liz Bassett is an associate in the Corporate Department of Paul, Hastings, Janofsky & Walker LLP in the Atlanta office. She is a member of the mergers and acquisitions practice group. Ms. Bassett received her B.A. in international relations, magna cum laude, from Tufts University in 2002. She received her J.D., with honors, in 2008 from Emory University School of Law. While in law school, she was a managing editor for the Emory Law Journal and published a comment on lobbying regulation reform.

Rachel Miles is an associate in the Corporate Department of Paul, Hastings, Janofsky & Walker LLP in the Atlanta office. She represents clients in a wide range of corporate transactional matters. Her experience includes mergers, acquisitions, advising clients on matters of corporate governance and assisting clients on general corporate

matters. Ms. Miles received her B.S. in Business Administration (with distinction) from the University of Kansas in 2003. She received her J.D. with high honors in 2006 from the University of North Carolina School of Law, where she was an Articles Editor for the North Carolina Law Review.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



11 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Thompson and Schwartz on Enhanced Scrutiny and Change of Control

2009 Emerging Issues 4084

Thompson and Schwartz on Enhanced Scrutiny in a Change of Control Scenario Under Lyondell: Director Actions and the Duty to Act in Good Faith

By Mr. Kenneth R. Thompson II and Mr. Michael G. Schwartz Esq.

July 29, 2009

SUMMARY: In the recently-decided Lyondell case, the Delaware Supreme Court examines what *Revlon* duties mean to independent, disinterested directors in a takeover situation, holding that such directors only breach their duty of loyalty if they utterly fail to attempt to obtain the best sale price.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ARTICLE: Introduction

In 1986, the Delaware Supreme Court issued its seminal *Revlon* decision, holding corporate directors have a fiduciary duty to obtain the best price for the company's stockholders when the company embarks on a transaction that will result in a change of control. Following the *Revlon* decision, the Delaware judiciary has examined the application of these *Revlon* duties in a variety of circumstances; however, the broad array of possible fact patterns left numerous unresolved issues. In the recently-decided case of *Lyondell Chem. Co. v. Ryan*, 2009 Del. LEXIS 152 (Del., March 25, 2009), the Delaware Supreme Court examines what *Revlon* duties mean to independent, disinterested directors in a takeover situation, holding that such directors only breach their duty of loyalty if they *utterly fail* to attempt to obtain the best sale price. This standard provides independent and disinterested directors with an extremely high level of protection and latitude in handling the potential sale of a company. The *Lyondell* court also clarifies and reaffirms several other aspects of a director's *Revlon* duties.

The Development of Enhanced Scrutiny in Delaware.

The concept of enhanced scrutiny in Delaware when reviewing a corporate change of control arose out of two cases decided by the Supreme Court of Delaware in 1985 and 1986. These cases, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) and *Revlon Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173 (Del. 1986), changed the landscape in how directors approach their roles in change of control situations. From the shareholder and potential purchaser's perspectives, enhanced judicial scrutiny is warranted due to the inevitable risk during a corporate change in control that a board may be acting in its own interest, and not that of the corporation and shareholders. *In re Lukens Inc. Shareholders Litigation*, 757 A.2d 720, 731 (Del. Ch. 1999). Under this heightened standard of review, courts perform a two-step evaluation of directors' actions: 1) determining the adequacy of the decision-making process employed by the

directors, including the information on which the directors based their decisions; and 2) examining the reasonableness of the directors' actions in light of the circumstances then existing. n1

Before *Unocal* and *Revlon*, courts evaluated board decisions under the more lenient business judgment rule n2, whereby the board's decision was presumed to be made on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company, as long as the board's decision was made for any *rational* reason. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The burden fell to the plaintiffs to prove that the directors were breaching their duties. This level of scrutiny came to be known as a "bare rationality" standard of review.

Under the *Unocal* and *Revlon* enhanced scrutiny tests, Delaware courts began to evaluate the objective *reasonableness* of a board's actions to determine whether the board complied with their fundamental fiduciary duties and fell within the protection of the business judgment rule. *In re Toys "R" Us, Inc. Shareholder Litigation*, 877 A.2d 975, 1000 (Del Ch. 2005). Even if the decision was rational, it also had to be objectively reasonable, or the burden fell on the board to prove that their actions were entirely fair. This enhanced scrutiny addressed the concerns of the courts regarding directors' decisions to sell control in a company from public or other minority stockholders to an individual or controlling entity, since the minority stockholders face the potentially permanent loss of both the strength of their voting power and the value of the control premium. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994). Enhanced scrutiny ensures that the minority stockholders can rely on the fiduciary duties owed to them by the directors, absent specific protections offered to them during a change in control.

The Revlon Duties: What Are They?

In the *Revlon* decision, the Supreme Court of Delaware described the duties imposed on a Delaware corporate board of directors when the company embarks on a transaction that will result in a change of control. In such case, the directors' duties owed to the shareholders switch from preserving the corporation and following the best long term strategy for growth, to the "maximization of the company's value at a sale for the stockholders' benefit." *Revlon* at 182. These fiduciary duties have become known as a Delaware corporate director's "Revlon Duties." n3

Revlon Duties include both a duty of care as well as a duty of loyalty, and the breach of either of these duties may result in the imposition of personal liability of a corporate director. Because of the high stakes typically involved in these takeover situations, clarity in defining the parameters of Revlon Duties has been sought by directors, shareholders and acquiring corporations. Such guidance can be found in both judicial and legislative actions.

Dealing with The Duty of Care -- Legislative Action Under Delaware §102(b)(7) Exculpatory Charter Provisions n4

In 1986, the Delaware General Assembly enacted Title 8, Section 102(b)(7) of the Delaware Code which permits stockholders to include a provision in a corporate charter limiting or eliminating directors' personal liability for breach of duty of care violations. *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001). Even if such a charter provision is adopted, injunctive proceedings based on gross negligence of the board may still be initiated by shareholders, and the provision does not limit the liability for directors acting in bad faith or who breach their duty of loyalty. However, the Delaware Assembly, as a matter of public policy, wanted to free up directors to take risks without worrying about negligence lawsuits, but not allow directors to have free reign to act as they pleased. *Id.* Thus, while a §102(b)(7) provision may eliminate personal monetary liability of directors for a breach of the duty of care, it does not eliminate the duty of care itself that is properly imposed upon directors. *Id.*

The *Lyondell* case is a good example of this policy. In the *Lyondell* case, the corporate Charter contained a Section 102(b)(7) provision. Thus, although the plaintiffs included a breach of the duty of care among its claims, the Court indicated the directors were protected from such claims by the 102(b)(7) provision. Thus, the sole issue examined by the *Lyondell* court was whether the directors breached their duties of loyalty. *Lyondell* at *10.

Judicial Clarifications of Revlon Duties

There have been a number of post-*Revlon* judicial decisions further defining the latitude and limits of a director's Revlon Duties when faced with a change of control situation. The *Lyondell* decision does an excellent job of pulling these decisions together in the context of independent disinterested directors. These issues include answers to the questions of when the Revlon Duties are triggered and what actions are required to comply with its mandates.

Revlon Duties: When Do They Apply?

The *Lyondell* court reiterated the fact that Revlon Duties are not triggered merely because a company is perceived in the financial community as being "in play" or "up for sale." *Lyondell* at *16, citing *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989). Rather, the duty to seek the best available price applies only when a company embarks on a transaction -- on its own initiative or in response to an unsolicited offer -- that will result in a change of control. *Id.*, citing *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 71 (1995). Delaware courts do not impose Revlon Duties on a board until such time as they abandon a long term strategy of corporate growth and initiate negotiations for the sale or reorganization of the company. There is no duty to immediately maximize short term shareholder value when directors are following a long term strategy for growth, and have not decided to dissolve or break up the company, even if the board is negotiating a merger or similar reorganization. *Time Inc.*, 571 A.2d at 1150-51. Similarly, *Revlon* duties do not apply to a board actively engaged in a merger or sale where control is passed from one fluid aggregation of unaffiliated stockholders to another, thus not concentrating voting power and control in the hands of an individual or single entity. *E.g.*, *Time Inc.*, 571 A.2d 1140; *Arnold v. Society for Sav. Bancorp, Inc.*, 678 A.2d 533 (Del. 1996).

In *Lyondell*, the Court rebuked the lower court for finding the Revlon Duties were triggered at the time the eventual acquiring corporation filed a Schedule 13D indicating its interest in acquiring the *Lyondell* corporation. At such time, the *Lyondell* directors did not consider the company to be for sale. Instead, their Revlon Duties were only triggered when the directors later decided to sell the company and began negotiating a price. Thus, the Court found the directors had no Revlon Duties during the time they were taking a wait-and-see approach to the possible acquisition. *Lyondell* at *17.

Revlon Duties: What is Required?

Once a director's Revlon Duties are triggered, even if the corporate charter contains a §102(b)(7) provision, the director has a duty of loyalty to the corporation which requires the director to act in good faith in pursuing the best possible price for the shareholders. *Lyondell* at *9-10. Several post-*Revlon* court decisions have examined what type of good faith efforts are sufficient to avoid personal liability of a director.

In the case of *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006), the Court discussed the range of conduct that might be characterized as bad faith and concluded bad faith encompasses not only an intent to harm but also intentional dereliction of duty. A few months after the *Walt Disney* decision, the Supreme Court of Delaware issued *Stone v. Ritter*, addressing the concept of bad faith in the context of an oversight claim:

[W]here a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation..only a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the lack of good faith that is a necessary condition to liability. *Stone v. Ritter*, 911 A.2d 362, 364 (Del.2006), quoting *In re Caremark Int'l Deriv. Litig.*, 698 A.2d 959, 971 (Del Ch. 1996).

The *Lyondell* Court pulled these concepts together in the context of independent, disinterested directors and declared that such directors only breach their duty of loyalty and its good faith requirement if they *knowingly and completely fail* to undertake their responsibilities. *Lyondell* at *21. The Court indicated the issue in such cases is not whether the directors did everything they should have done to obtain the best sale price. Rather, the inquiry is whether the directors *utterly failed* to attempt to obtain the best sale price. *Id.*

In examining a directors' actions in these situations, their decisions are required to be reasonable, but not perfect. *Lyondell* at *20-21, citing *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994). There is only one *Revlon* duty, and that is to get the best price for the shareholders. No Court can tell directors exactly how to accomplish such goal, because they will be facing a unique combination of circumstances, many of which will be outside their control. There is no single blueprint a board must follow to fulfill its duties. *Lyondell* at *18.

Conclusion

Lyondell highlights the importance of having an independent and disinterested board. Where the board is not independent and disinterested, the directors may have the burden of establishing the "entire fairness" of the transaction. Under *Lyondell*, even if a §102(b)(7) provision is included in the company's charter, such company's board should be advised of their duties of care and loyalty, but the duty of loyalty, and specifically the duty to act in good faith, is paramount if looking to avoid personal liability for board actions in a change of control scenario. This duty can be satisfied by making reasonable efforts that demonstrate the board's recognition of their duties, and a reasonable attempt to obtain the highest value for the shareholders of the company. There is no requirement to auction the company, conduct a market check, or demonstrate "an impeccable knowledge of the market," as the lower court in *Lyondell* would have required. *Ryan v. Lyondell Chem. Co.*, 2008 Del Ch. LEXIS 105 (Del Ch., July 29, 2008). The board must simply act in good faith by not intentionally ignoring such duty to act for the benefit of the corporation and shareholders.

Additional Information

For more on the board's fiduciary duties, see the M&A Practice Guide, Chapter 3, "Corporate Law Issues."

[Return to Text](#)

n1 Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 *Del. J. Corp. L.* 769, 858 (2006).

n2 For a full discussion on the business judgment rule, see Delaware Law Of Corporations & Business Organizations Sec. 4.30 (LexisNexis Matthew Bender).

n3 For a more detailed description of the *Revlon* Duties, see 1-12 Corporate Governance: Law and Practice § 12.05 (LexisNexis Matthew Bender).

n4 For an analysis of Section 102(b)(7) exculpatory provisions in Delaware corporate charters, see John L. Reed and Matt Neiderman, "Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty", 29 *Del. J. Corp. L.* 111.

n5 For a review of *In re Disney*, see Wolfe, Donald J., and Pittenger, Michael A. In *Re The Walt Disney Company Derivative Litigation*. LexisNexis Expert Commentary, February 20, 2008.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ABOUT THE AUTHOR(S):

Kenneth R. Thompson II is Senior Vice President and Global Chief Legal Officer for LexisNexis, a division of Reed Elsevier Inc. His core areas of expertise are intellectual property, acquisitions and divestiture, anti-trust, and Internet security issues. Indeed, in line with his security focus, the Chief Security Officer now reports to Ken, overseeing the governance and protection of the vast quantities of information that LexisNexis gathers and stores. As a member of the LexisNexis Group Management Committee, Ken leads and advises at the highest levels of the company. He also remains the principal legal advisor to the LexisNexis Global Chief Executive Officer. His broad expertise makes him an authoritative and highly engaging public speaker on his area of expertise.

Michael G. Schwartz is a partner at Vorys, Sater, Seymour and Pease LLP, in the Cincinnati office, and is a member of the probate and tax practice group. He represents individuals and closely-held businesses in all facets of estate and business planning. His estate planning experience ranges from simple to the most complex estate plans. Mr. Schwartz is a frequent speaker on advanced estate and business planning topics at professional education seminars, including the Southwest Ohio Tax Institute, the Advanced Estate Planning Institute and the Midsouth Estate Planning Conference.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



12 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Jeffries & Snider on The Enforceability of No Talk and No Shop Covenants

2009 Emerging Issues 3607

Browning Jeffries and R. Samuel Snider on The Enforceability of No Talk and No Shop Covenants under Delaware Law -- A Survey of IXC, Toys "R" Us, Phelps Dodge and Ace

By Browning Jeffries Esq. and R. Samuel Snider Esq.

May 6, 2009

SUMMARY: Parties to M&A transactions often agree to a range of provisions intended to protect a buyer from interloping bidders. This article focuses on the enforceability of "no shop" provisions that prohibit a target company from soliciting or encouraging third-party bids after signing an agreement with a prospective purchaser, and "no talk" provisions, that prohibit any discussions or negotiations between the target and unsolicited bidders.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ARTICLE: Parties to M&A transactions often agree to a range of provisions intended to protect a buyer from interloping bidders, including exclusivity provisions (in the form of no shop or no talk covenants), break-up fees, voting agreements, stock options, and many others. Such provisions are routinely challenged by other bidders or target company stockholders, and, as a result, Delaware courts have established an extensive body of jurisprudence on the enforceability of deal protection provisions. This article focuses on the enforceability of exclusivity provisions -- specifically "no shop" provisions that prohibit a target company from soliciting or encouraging third-party bids after signing an agreement with a prospective purchaser, and "no talk" provisions, the no shop's more draconian cousin that not only prohibits active solicitation, but also prohibits any discussions or negotiations between the target and unsolicited bidders.

Analytical Framework for No Shop / No Talk Provisions

Delaware courts generally accept that deal protection provisions have a place in deal making because they can enhance a target's stockholder value by incentivizing a purchaser to pay a higher purchase price in exchange for the assurance of not becoming a stalking horse for subsequent bidders. However, Delaware courts are also leery of the potential of deal protection devices to limit a target board's ability to respond to subsequent higher bids and the possibility of abuse resulting from conflicts of interest between board members, management, and stockholders. As a result, Delaware courts pay close attention to such provisions, analyzing them using similar approaches under either the business judgment rule or enhanced scrutiny framework.

Such reviews are fact dependent, however, and make it difficult to derive hard-and-fast rules about whether a specific exclusivity provision will be enforced. However, an analysis of the leading cases addressing no shops and no

talks suggests some interesting patterns. The first of these patterns is that the decision of whether to apply the business judgment rule or enhanced scrutiny is not necessarily outcome determinative, and the facts of the case seem to be more important than the analytical framework a particular court applies.

The second arises from the facts of the cases themselves. It appears that, more than any other factor, the best predictor of whether a no shop or no talk will be enforced is whether another bidder is at the table when the case appears before a Delaware court. Delaware courts seem suspicious of cases brought by target company stockholders claiming that a board breached its fiduciary duties in entering into exclusivity provisions absent another bidder in the game. On the other hand, when another bidder or a target stockholder challenges a no shop or no talk in connection with a potentially topping bid, Delaware courts seem quite willing to reject the provision and throw the target company back into auction.

The Case For Enforcing No Shop / No Talks -- IXC and Toys "R" Us

These trends are exemplified by two of the landmark no shop / no talk cases -- the 1999 decision in *n1* and 2005's *n2*. Both of these cases involved target company stockholders suing to enjoin stockholder votes on proposed mergers. Significantly, in both cases the target companies had engaged in extensive market checks prior to executing agreements with their ultimate purchasers, and neither target had been approached with a potentially topping bid.

After IXC's stock price deteriorated as a result of slowing earnings growth, the company announced that it had retained an investment banker to consider strategic alternatives. A large number of telecommunications companies approached and IXC entered into relatively serious discussions with a few players. After roughly six months of discussions, Cincinnati Bell and a financial sponsor met with IXC to discuss a potential merger. The companies ultimately executed a merger agreement that included a number of deal protection devices including a no talk, a \$105 million termination fee, a cross-option agreement, and a side deal with IXC's largest stockholder. Plaintiff, an IXC stockholder, sued to enjoin IXC's stockholder vote on the merger. Plaintiff's major contention was that the IXC board breached its duty of care by attempting to circumvent its duties by driving away suitors other than Cincinnati Bell, and agreeing to a no talk that prevented the board from considering other offers (relying on language in the then-recently decided case, which we discuss below).

Focusing on the no talk for purposes of this article, the Chancery Court held that the provision was not a defensive mechanism instituted to respond to a perceived threat of a potential acquirer and therefore was reviewable under the business judgment rule (rather than an enhanced scrutiny analysis), and was thus "granted deference." *n3* The court then focused on the fact that the no talk provision was agreed to very late in IXC's sale process after what the court concluded was an extensive market check, and that IXC did not in fact receive any superior offers following the announcement. The court found that, as a practical matter, the no talk did not limit the board's ability to respond to new bids. It is particularly interesting that the court took notice that the no talk provision was actually waived by IXC and Cincinnati Bell, with Cincinnati Bell agreeing to an express fiduciary out concept, but the court ruled that regardless of the waiver, "provisions such as these are common in merger agreements and do not imply some automatic breach of fiduciary duty." *n4*

Much like, involved a suit by a group of Toys "R" Us stockholders seeking a preliminary injunction against a stockholder vote to approve Toys "R" Us's acquisition by a private equity consortium. In response to market pressures, the Toys "R" Us board engaged in a comprehensive strategic review and multi-round auction in which it received attractive bids for a portion of its business. In the final stage of the auction two bidders engaged in a bidding war for the company as a whole. This put the board in the unenviable position of having to decide whether to reopen the auction process for the company as a whole, likely losing the attractive bids for its "toys" division, or allow a very short limited bidding contest between the two bidders for the entire company.

The plaintiffs challenged the board's action on two grounds -- a claim that the board failed to maximize stockholder value by allowing only a limited auction for the company as a whole, and a -type claim that the deal

protection measures agreed to by the Toys "R" Us board precluded the emergence of topping bids. n5 The deal protection package included a no shop provision subject to a fiduciary out, together with a 3.75% break-up fee and a matching right for the initial bidder. Taking the opportunity to apply enhanced scrutiny to determine whether the board acted reasonably and whether the deal protection devices were draconian, Vice Chancellor Strine found that the board acted reasonably, and that its deal protection mechanisms were not draconian given the extensive auction process, absence of topping bidders, and compelling financial return to the Toys "R" Us stockholders from the existing bid. It is interesting to note, however, that the court felt that it would have reached the same conclusion applying the business judgment rule as applied in , stating that "although using the business judgment rule framework, [the decision] involved a hard look at the reasonableness of deal protections, consistent with a properly conducted reasonableness review that gives due deference to the board's judgment." n6

The Case Against Enforcing No Shop / No Talks -- Phelps Dodge and Ace

Two cases decided almost simultaneously with provide the counterpoint to the deference given to the boards' actions by Delaware courts in and -- 1999's . n7 and n8. In , Cyprus and Asarco Inc. had agreed to merge and to submit the merger to a stockholder vote, when Phelps Dodge made an unsolicited hostile offer to purchase all of the shares of either or both companies for a 25% premium and brought suit to enjoin a vote on the merger.

In a bench ruling, the court expressed significant concern over the no talk provision (as well as the termination fee) in the Cyprus/Asarco merger agreement because the no talk "prevent(s) a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party." n9 In other words, in Chancellor Chandler's view, no talks can result in a breach of the duty of care by prohibiting in advance a board's ability to make a fully informed decision with respect to a recommendation to consummate a transaction, and that by agreeing to a no talk the board imposed on itself "willful blindness" to potential topping offers. n10

Interestingly, Chancellor Chandler made it quite clear that he did not feel it necessary to apply enhanced scrutiny because Phelps Dodge was likely to win on the merits of the case even under a traditional business judgment rule analysis. Ultimately, however, Chancellor Chandler ruled against Phelps Dodge, basing his holding on Phelps Dodge's failure to demonstrate the threat of irreparable injury rather than failure to prove a likelihood of winning on the merits in its challenge to Cyprus's board actions. Phelps Dodge's irreparable injury claim was based on its self-avowed intent to walk away from any bid if the Cyprus/Asarco merger was consummated. Chancellor Chandler felt that a plaintiff's self-imposed injury is not sufficient to enjoin a stockholder vote when the stockholders are fully informed of a potential topping bid and can cast their votes accordingly.

Essentially, Chancellor Chandler gave strong credence to the de facto ability of an intervening bidder to make a topping bid directly to a target's stockholders, and as long as the stockholders themselves were not precluded from rejecting the original deal and subsequently entering into the topping transaction, the matter was properly in the hands of the stockholders. An intervening bidder cannot prove irreparable harm simply by arguing that the bid it would have to put forward to induce a target's stockholders to reject a deal already in hand would not be commercially viable, though that may be one factor in the court's analysis.

The acquiror sought to use a no talk provision in a merger agreement as a sword to prevent its target, Capital Re, from terminating the merger agreement and consummating a transaction with an intervening bidder. After Capital Re had agreed to the no talk with Ace, XL Capital made a topping bid and Capital Re engaged in negotiations with XL Capital. Ace argued that the merger agreement's no talk provision required Capital Re, before it would be allowed to respond to any third party bid, to have a written opinion of outside counsel stating that the directors were required to entertain a particular third party bid to comply with their fiduciary duties. Since Capital Re's counsel had not provided such a definitive statement in writing, Ace argued, Capital Re was not excused from the no talk. However, Capital Re argued (and the court agreed) that while it could consider the advice of counsel, the directors themselves ultimately had to determine what actions were necessary to comply with their fiduciary duties.

The substantive decision hinges on the very case-specific contract interpretation question of the meaning of a provision requiring Capital Re's board to conclude "in good faith .. based on the written advice of its outside legal counsel, that participating in [negotiations with a third party] is required in order to prevent [the board] from breaching its fiduciary duties." n11 Ace argued that this provision required the board's outside counsel to provide a definitive opinion that a topping bid triggered the board's or other duties before negotiating with the topping bidder, whereas Capital Re argued that the ultimate decision must be made by the board.

The court examined this argument through two lenses. First, as a matter of contract interpretation, Vice Chancellor Strine found that Capital Re's reading of the contract was likely to prevail at trial, and this short decision was itself likely dispositive of the matter. Second, however, Vice Chancellor Strine engaged in an ambitious and wide ranging analysis of whether, if read as Ace suggested, the provision was enforceable. This analysis hinges on the public policy weight one applies to fiduciary obligations versus a third party's right to an enforceable contract, examined through three of four factors in a framework developed by Professor Paul Regan.

The first of these factors looks at whether the acquiror knew or should have known of the target board's breach -- basically, a sort of buyer beware policy with respect to overly aggressive lockup provisions. Although treated as a fact specific analysis, this analysis raises serious questions about whether a full-blown no talk is *ever* appropriate because a no talk that operated as Ace proposed "comes close to self-disablement by the board." n12

In many ways the opinion foreshadows by considering whether to apply a -style enhanced scrutiny analysis to the no talk as a result of Ace's contention that with no duties applicable in a non-change of control setting (*i.e.*, a stock-for-stock merger), the Capital Re board was free to more fully lock up the transaction. However, the court side stepped ruling on 's applicability by finding that regardless of whether applied, boards are still obligated to exercise their "bedrock duties of care and loyalty" and if a board mistakenly enters into an agreement in which it believed it preserved its rights to hear topping bids but failed to actually do so, such an event would likely be a breach of the duty of care. This dicta had far reaching effects, making strong, target-friendly fiduciary outs commonplace in all types of transactions, whether change of control or otherwise.

The second factor -- whether the transaction remained pending or was already consummated at the time of decision -- was discussed briefly. The thrust of this inquiry is the extent to which the acquiror would be harmed by unwinding a provision in the merger agreement. If the deal had closed, rendering the merger agreement unenforceable would require the dramatic and costly remedy of rescinding the deal, whereas if the deal is not yet closed the acquiror would suffer much less damage.

The court's analysis of the third factor addresses head on a question that most practitioners will hear from their clients at some point -- whether the public policy interest of enforcing arms-length contracts outweighs the public policy interest of protecting fiduciary obligations. Or, as our clients put it -- "what's the point of signing a contract that says our target can't talk to other people if the court's just going to tell them they can anyway?!" Vice Chancellor Strine makes this explicit, holding that if a board breaches a fiduciary duty, and the other party to the contract was instrumental in causing the duty to be breached (*i.e.*, by negotiating for an unenforceable position), the public policy of enforcing that contract is outweighed by the public policy of protecting stockholders from the board's actions.

Conclusions

It is difficult to draw too many conclusions from an analysis of no shop and no talk provisions outside of the broader lockup context reinvigorated by cases like . However, practitioners can draw a few important inferences from these cases. The first is that the facts of the case matter. Vice Chancellor Strine tried to rebuff this view in by stating that "just as the later emergence of a topping bid does not necessarily mean that the board acted unreasonably in protecting an earlier bid it believed to be the most favorable, the absence of a later topping bid did not mean that the board's prior actions were not unreasonable." n13 As a practical (if not doctrinal) matter, however, it is striking that the cases in which a no shop or no talk were upheld are the same cases in which no topping bid was on the table.

A second inference is that the party bringing the case matters. Delaware courts are likely to support a stockholder suit, a suit by a target, or a suit by a competing bidder challenging a no shop or no talk if a competing bid is on the table, weighing the opportunity to allow stockholders to decide for themselves whether to accept a higher bid above the rights of a contacting party. However, it will be interesting to see what happens if Delaware courts are presented with a repeat of the scenario in which a buyer tries to enforce a no talk as a sword to keep the target from exercising fiduciary outs. It seems unlikely that a Delaware court will ever be sympathetic to a buyer in this situation.

A third inference has important drafting implications, and that is that under the approach developed by Vice Chancellor Strine, buyers are charged with knowing whether a no shop or no talk is unenforceable. Although primarily applicable when weighing a target board's fiduciary obligations against an acquiror's contract rights, practitioners representing acquirors must be careful to ensure that their provisions are well within the realm of enforceability, and one could see clever and creative target counsel proposing an overbroad no shop, no talk or bundle of lockup mechanisms as a safety net in case of a future topping bid.

From the three takeaways noted above, it would appear that exclusivity provisions -- particularly no talk provisions -- have limited utility if they will not be enforced in the face of a topping bid and are subject to extensive fiduciary out obligations. Even though it is not possible to completely lock up a public company transaction, no shops and no talks do, however, remain important tools for an acquiror. These protections can serve to shut down active solicitation of other bids, create a framework in which a topping bid will be addressed, provide notice of a topping bid to the acquiror, sometimes provide additional deal protection in the form of matching rights or other provisions designed to assist an acquiror in defending its deal, and force a target to "play by the rules" with respect to other potential bidders. Delaware courts recognize the value of these provisions in allowing a bidder to offer a higher price in exchange for greater certainty of closing, and provided that the provisions are not draconian or unreasonably tie the hands of a board of directors, the devices remain an important tool in an acquiror's transaction tool kit.

[Return to Text](#)

n1 1999 *Del. Ch. LEXIS 210* (Oct. 27, 1999).

n2 877 A.2d 975 (*Del. Ch. 2005*).

n3 1999 *Del. Ch. LEXIS 210* at *29.

n4 1999 *Del. Ch. LEXIS 210* at *17.

n5 For more on *Revlon*, see Wolfe and Pittinger on *Revlon, Inc. and new standard of judicial review, 2008 Emerging Issues 1934*.

n6 877 A.2d at 1016, n. 66.

n7 1999 Del. Ch. LEXIS 202 (Sept. 27, 1999).

n8 747 A.2d 95 (Del. Ch. 1999).

n9 1999 Del. Ch. LEXIS 202 at *4.

n10 1999 Del. Ch. LEXIS 202 at *4.

n11 747 A.2d at 98.

n12 747 A.2d at 107.

n13 877 A.2d at 1016, n. 68.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Browning Jeffries is an Assistant Professor of Law at Atlanta's John Marshall Law School, where she teaches a number of courses, including Transactional Drafting. Prior to joining the faculty in 2007, Ms. Jeffries practiced in the corporate department of the Atlanta office of Paul, Hastings, Janofsky, & Walker LLP. At Paul Hastings, she represented a wide range of companies in a variety of mergers, acquisitions, and other business combination transactions as well as general corporate matters.

Sam Snider is Vice President and Lead Acquisition Counsel for LexisNexis, a division of Reed Elsevier Inc. He is responsible for all aspects of LexisNexis global mergers, acquisitions, divestitures and restructuring activities, including numerous acquisitions in the United States, Europe and Asia. In addition, he leads the Outsourcing and Offshoring and U.S. Legal Compliance teams within the LexisNexis legal department. He is a frequent writer and

speaker on corporate law and M&A matters and was named a Georgia Rising Star by *Atlanta Magazine* and *Georgia Super Lawyers-Rising Star Edition*.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



13 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Snider, Patel, and Smoak on Risk Allocation & Current Insights on MAC Clauses

2009 Emerging Issues 3600

Accounting for the Unknowable: Risk Allocation & Current Insights on Material Adverse Change Clauses

By R. Samuel Snider Esq., Rahul Patel Esq. and Will Smoak Esq.

May 5, 2009

SUMMARY: Recent turmoil in credit markets and the economy has brought back the Material Adverse Change (MAC) clause into common parlance in negotiated transactions as purchasers in deals struck before the liquidity crunch are relying on such provisions to attempt to nullify transactions. This article examines the modern view of MAC clauses in the Delaware courts.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: "[T]here are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns-the ones we don't know we don't know."

-- Former U.S. Defense Secretary Donald Rumsfeld, on the inherent difficulties of evaluating risk in the national security and intelligence arenas

One of the challenging tasks that parties negotiating a transaction face is accounting for the unknown. Practitioners utilize a number of tools to accomplish this, such as deal protection and fiduciary out clauses to address potential intervening bidders, representations and warranties to confirm a purchaser's due diligence and allocate risk associated with the limitations of due diligence inquiries, caps and baskets to establish a threshold below which an unknown risk is deemed immaterial, and many others.

However, these provisions are designed to provide financial remedies for unknown events that may reduce the value of the transaction to a purchaser, or increase the value of another transaction to a seller. As recent turmoil in credit markets and the economy has highlighted, parties to a negotiated transaction must also account for "black swan" risks-the risk of an event that is so deleterious to the target company's value that the purchaser should be excused from consummating a negotiated transaction. Practitioners account for such risk using "material adverse change" (MAC) clauses. Because such provisions are the "nuclear option" in M&A transactions, they are rarely utilized and even more rarely litigated. However, the financial crisis has brought the MAC clause back into common parlance as purchasers in deals struck before the liquidity crunch have relied on such provisions to attempt to nullify transactions. n1 This article examines the modern view of MAC clauses in the Delaware courts.

Focusing on Delaware Court of Chancery cases, three recent decisions have provided broad commentary on MAC provisions. While practitioners can draw distinct lessons from each of these decisions, several common themes emerge. First, Delaware courts have placed strong emphasis on the particular facts presented in a case and therefore are prone to consider extrinsic evidence in an attempt to discern the intent of the contracting parties. Second, the decisions reveal an emphasis on the doctrine of caveat emptor-and the corresponding allocation of risk to the purchaser-with respect to events and circumstances which the parties either knew (or were capable of discovering) at the time the contract was formed. Finally, Delaware courts evaluate the materiality concept contained in a MAC clause from the point of view of a reasonable purchaser with a long-term investment horizon.

In re IBP

Decided in June 2001, *In re IBP, Inc. Shareholders Litigation* n2 involved Tyson Foods' \$4.7 billion purchase of IBP, the country's largest beef processor and second largest pork processor. The acquisition agreement was the product of a competitive auction that pitted Tyson against Smithfield Foods, the nation's largest pork processor. Tyson's eagerness to beat out Smithfield in the auction was palpable. In the face of substantial uncertainty over accounting irregularities at one of IBP's subsidiaries, and knowing that the livestock processing business was entering a cyclical trough, Tyson submitted not one but two topping bids.

After the agreement was executed but prior to closing, both IBP's and Tyson's businesses began to suffer. Owing to the anticipated cyclical downturn in the market for cattle and an unusually harsh winter (which further exacerbated the downturn), IBP reported a significant decline in performance. In arguing that IBP had suffered a MAC, Tyson focused on IBP's results during the fourth quarter of 2000 (for which financial statements were not yet available at the time of signing) and the first quarter of 2001, as well as the magnitude of the impairment charge required by the accounting irregularities. Indeed, IBP's first quarter 2001 earnings were off 64% from the prior year, and the accounting problem resulted in a one-time charge of between \$0.50 and \$0.60 per IBP share.

Although "confessedly torn about the correct outcome" as to whether IBP had suffered a MAC, n3 the court ultimately determined that Tyson had not met its burden, holding that even where a MAC condition is "broadly written," n4 it is "best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner." n5 To be material, an adverse change must be "consequential over a commercially reasonable period . . . measured in years rather than months." n6

Simply put, the evidence Tyson presented did not satisfy this "durationally-significant" requirement. If IBP's first quarter 2001 performance was extrapolated linearly, the decline indeed would have "deviate[d] materially from the range in which IBP had performed during the recent past." n7 But by the time of trial, IBP's earnings had begun to recover. Even at the low end of the average analyst predictions, the court found that IBP's earnings for the following two years "would not be out of line with its historical performance during troughs in the beef cycle." n8 Therefore, while IBP's "blip" in earnings caused by the accounting impairment charge and the aberrational winter might be material to a short-term investor, the court determined that these setbacks were not "material when viewed from the longer-term perspective of a reasonable acquiror." n9

Providing further direction for practitioners, Vice Chancellor Strine acknowledged that determining materiality for purposes of a MAC clause requires a court to "engage in an exercise that is quite imprecise" and that the provision "must be read in the larger context in which the parties [are] transacting." n10 The factually-sensitive nature of the inquiry, then, means that a MAC dispute rarely-if ever-is capable of disposition by a court on a summary judgment motion. Additionally, the court observed that a purchaser "ought to have to make a strong showing to invoke a [MAC] exception to its obligation to close" because acquisition agreements are "heavily negotiated and cover a large number of specific risks explicitly." n11 Thus, the *IBP* decision suggests that, consistent with the doctrine of caveat emptor, it is the purchaser's obligation to insist upon provisions that preserve its ability to terminate the contract insofar as known or knowable risks are concerned.

The April 2005 case of *Frontier Oil Corp. v. Holly Corp.* n12 involved a dispute between two mid-sized petroleum refiners that had previously agreed to a \$450 million merger. Prior to executing a definitive agreement, Holly learned that a class action plaintiff planned to file a mass toxic tort suit involving a crude oil processing facility formerly owned by Wainoco Oil & Gas, a Frontier subsidiary. A legal memorandum prepared by Holly's counsel noted that although not a slam dunk for the plaintiff, the case posed a substantial monetary risk because, among other things, the story "would be attractive to a lay jury" and that recent change in California law would make it difficult for Frontier to obtain summary judgment. Despite these risks, Holly proceeded to sign the merger agreement in part based on the belief that, since Wainoco was a Frontier subsidiary, a "corporate separateness" defense was available whereby Frontier might escape any liability.

Subsequent developments drastically undermined this belief. The plaintiff filed its lawsuit and, pursuant to a document which was neither discovered by Holly during due diligence nor directly provided by Frontier, direct contractual obligations existed requiring Frontier to provide indemnity for losses arising from the type of injury the plaintiff asserted. After attempts to renegotiate the terms of the merger failed, Holly sent notice to Frontier that the toxic tort case constituted a breach of its contractual representation that no litigation existed (or was threatened) which "would have or reasonably be expected to have a [MAC]" on Frontier. n13

In evaluating the MAC issue, the court first noted the importance of the need for a forward-looking analysis because the parties chose to incorporate the "reasonably be expected to have" language into the scope of inquiry regarding threatened litigation. However, the court then proceeded to reiterate and adopt the *IBP* standard of materiality, , an unknown event that substantially threatens the overall earnings potential of the target in a durationally-significant manner.

While observing that the litigation indeed could prove catastrophic to Frontier with judgments running into the hundreds of millions of dollars, Vice Chancellor Noble's holding that a MAC did not exist can be attributed both to a legal ruling and to a factual finding. As to the former, the court held that, in the absence of a contractual allocation of the burden of proof, the party seeking to avoid performance of the agreement bears such burden. Holly thus was required to show a MAC by a preponderance of the evidence. As to the latter, the court found that Holly had not "demonstrated (or even seriously tried to demonstrate) the likelihood" of an adverse judgment by means of competent factual and opinion testimony that would have allowed the court to make an informed judgment as to the probability and magnitude of the loss. The only evidence Holly presented with any certainty was with regard to anticipated defense costs which, at approximately 6% of Frontier's enterprise value, were insufficient to constitute a MAC.

As the decision in *Frontier Oil* makes clear, it is essential for a litigant to provide thorough analysis, projections and expert evidence in order to prevail on a MAC claim premised on a forward-looking contingency. Even if the magnitude of a potential event is cataclysmic, probability must be shown. Furthermore, the party bearing the burden of proof inherently risks an adverse outcome if the materiality determination is simply "too close to call." In a footnote to his opinion, Vice Chancellor Noble noted that this decision fell into that category, stating "[s]ometimes a court is able to deflect the import of allocating burdens by opining that, regardless of who has the burden, the outcome would be the same. This case is not so convenient." n14

The most recent installment in the Court of Chancery's MAC jurisprudence is the September 2008 case of *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* n15 In June 2007, Hexion, the world's largest producer of industrial resins and a portfolio company of private-equity giant Apollo Global Management, signed a merger agreement to acquire Huntsman, a global chemical manufacturer, for approximately \$10.6 billion in cash. As a result of an intense bidding war between Hexion and a competitor, the merger agreement was quite favorable to Huntsman-so much so that despite Hexion's intention to finance virtually the entire purchase price, its obligation to close was not conditioned on the availability of financing.

Following execution of the agreement, global credit markets deteriorated precipitously and the transaction became significantly less attractive to Hexion. Thereafter, Hexion filed suit in June 2008 seeking a declaratory judgment that,

among other things, Huntsman had suffered a MAC, thereby excusing Hexion's obligation to consummate the transaction. In advancing its argument that a MAC had occurred, Hexion focused on three factors: (i) Huntsman's decline in earnings since June 2007; (ii) an increase in Huntsman's net debt since the merger agreement was signed; and (iii) the lagging performance of two of Huntsman's business divisions.

The court's analysis emphasized the core teachings of *IBP*, noting that, absent evidence to the contrary, "a corporate acquiror may be assumed to be purchasing the target as part of a long-term strategy" n16 and that a "significant decline in earnings by the target" after signing could constitute a MAC only if the purchaser showed those results were "expected to persist significantly into the future." n17 Moreover, Vice Chancellor Lamb followed *Frontier Oil* for the proposition that, "absent clear language to the contrary" contained in the agreement, the burden of proof rests on the party arguing that a MAC has occurred. This burden, the court noted, is a "heavy" one, for it is not mere coincidence that "Delaware courts have never found a [MAC] to have occurred in the context of a merger agreement." n18

Applying this analytical framework to Hexion's argument regarding Huntsman's earnings performance, Vice Chancellor Lamb first noted that although Huntsman's actual operating results during the period following signing significantly missed management projections provided during the diligence process, this alone could not form the basis for a MAC because the merger agreement contained a provision disclaiming any representation or warranty regarding management's projections. Instead, the court adopted the opinion of Huntsman's expert that the language found in the MAC definition ("financial condition, business or results of operations") was a term of art used in federal securities law that requires a company to compare its financial results with results during equivalent periods from the prior year. The court went on to compare Huntsman's EBITDA for its 2007 fiscal year with its 2006 fiscal year, noting only a 3% decline, and Huntsman's trailing twelve-month EBITDA for the second quarter of 2008 to its trailing twelve-month EBITDA for the second quarter of 2007, observing a mere 6% decrease. n19 Vice Chancellor Lamb then examined various fiscal year 2008 EBITDA projections to actual 2007 results, which revealed a decline of between 7% and 11%. Finally, analyst estimates of Huntsman's 2009 EBITDA showed only a 3.6% decline relative to fiscal year 2006 and an "essentially flat" result relative to fiscal year 2007.

After concluding that Huntsman's decline in earnings did not constitute a MAC, the court quickly dispensed with Hexion's other two arguments. As to the net debt argument, because Hexion's initial valuation models assumed Huntsman's net debt to be comparable to the level which existed at the time of the lawsuit, "Hexion [could not] now claim that a 5% increase in net debt . . . even combined with the reduced earnings, should excuse it from its obligation to perform on the merger agreement." n20 Moreover, since the difficulties experienced at Huntsman's two divisions likely were short-term in nature and not material to Huntsman *when viewed as a whole* (the divisions were expected to contribute only 25% of Huntsman's 2008 EBITDA), Hexion's argument on this front failed as well.

The *Huntsman* case adds several critical elements to MAC jurisprudence. First, the court provided a theoretically sound basis for employing EBITDA—rather than earnings per share—as the relevant benchmark for future cases in deciding whether a MAC has occurred. Earnings per share is very much a function of the capital structure of a company, reflecting the effects of leverage. EBITDA, on the other hand, is a better measure of the operational results of the business because it is independent of capital structure. Second, the court addressed how carve-outs function within the MAC definition. Absent contractual language which specifies otherwise, a Delaware court will not evaluate the effect of carve-outs and "disproportionate impact" language before first determining the circumstances in fact amount to a material adverse change on the target company. Seemingly, the court reasoned that it would be logically incoherent to allow a litigant to manufacture the existence or non-existence of a necessary condition (the material adverse change) through the use of such carve-outs and language without having shown the existence of such condition *ab initio*.

In light of the Delaware cases that have interpreted MAC provisions, corporate attorneys should consider the following principles during the negotiation and drafting process:

- Typically, acquisition agreements do not specify either a percentage or dollar-value decrease in an economic benchmark, or a time period for testing such decrease, that would function to trigger a MAC clause for purposes of materiality. Practitioners should note that in the absence of an express contractual standard, a court will engage in a fact-intensive review to determine materiality in terms of the parties, their intent, their knowledge of risks at the time of contracting and the particular industry in question. Moreover, a purchaser should be aware that while specificity can provide a clear path to terminate the agreement, such specificity can place the purchaser at a disadvantage in terms of renegotiating the deal if the contractually-defined benchmark has not been met.
- In the *Huntsman* decision, the Court of Chancery made clear that while a party invoking the MAC provision has the burden of proof, a contractual agreement to otherwise allocate (, the burden is always on the seller to disprove a MAC) or modify (, a clear and convincing standard, rather than a mere preponderance) that burden likely is enforceable. Such a provision could alter the nature of a MAC clause from a "purchaser backstop" into a "purchaser weapon," thereby providing the purchaser with substantial leverage in renegotiating the deal or successfully litigating its termination of the contract.
- An overarching theme in *IBP* was that if an issue surfaces in diligence and the purchaser does not allocate that risk in the agreement, a reviewing court likely will hold such sloppiness against the purchaser in future litigation. Information requests from the seller should be thorough and precise. Senior lawyers should pay particular attention to the breadth and substance of the disclosure schedules and should follow up on missing or inadequate information and "red flags." Once material risks are identified, the parties should provide for them in closing conditions or otherwise allocate them in the contract (perhaps through a price concession), rather than relying on a MAC clause.
- The Delaware cases teach that if the purchaser is relying on projections, estimates or other forecasts provided by seller's management, the MAC clause should reflect this understanding and should not be undermined by other provisions of the agreement. For instance, in *Huntsman*, the court refused to evaluate the seller's performance against management's projections because of a specific disclaimer included in the contract. In *IBP*, the court heavily discounted the relevance of management's forecasts because at the time the agreement was signed, the purchaser, by its own admission, had little confidence in management's ability to accurately predict the seller's future performance.
- In the Hexion-Huntsman merger agreement, the MAC definition contained a carve-out for industry-wide effects, unless they had a disproportionate impact on Huntsman. Hexion argued that determining whether a MAC had occurred necessitated comparing Huntsman's performance against that of the industry in general. The Court of Chancery rejected this approach and held that, as the MAC definition was drafted, the first analytical step was to determine whether the seller had suffered a MAC; only then did the carve-outs come into play. In other words, the existence of a carve-out providing that there is no MAC if the seller's results are consistent with other firms in the industry does not mean that a MAC necessarily exists if such results are significantly different than those of other industry players. Based on this interpretation, if a purchaser wishes to determine whether there has been a MAC by looking at the disproportionate impact of market conditions on the seller, it should attempt to negotiate that point of reference directly in the MAC definition (, separate from the carve-outs). Additionally, each transaction may have industry-, seller-, and deal-specific areas of concern that may be appropriate to treat in this fashion. An attorney should communicate with his or her client to identify these areas and fully understand the inherent risks of the seller's business and industry.
- MAC clauses are not just creatures of purchase agreements. Financing commitment documentation may also contain MAC "outs" for the lender. Attorneys for the purchaser should strive to negotiate uniformity between the financing MAC provisions and the MAC provisions in the substantive acquisition agreement. Otherwise, a purchaser could face a situation where a lender is entitled to terminate the financing commitment, but the purchaser is still obligated to close the transaction. Such coordination may be increasingly feasible for purchasers given the current economic climate. Moreover, cash-strapped sellers may accede to "financing outs" or more favorable financing covenants in the purchase agreement independently of the MAC provisions

[Return to Text](#)

n1 Examples include J.C. Flowers & Co.'s scuttled acquisition of Sallie Mae, Lone Star's purchase of Accredited Home Lenders, and Harman International's abandoned buyout by Kohlberg, Kravis, Roberts & Co. and Goldman Sachs.

n2 789 A.2d 14 (*Del. Ch. 2001*).

n3 789 A.2d at 71.

n4 The merger agreement defined a MAC as "any event, occurrence or development or a state of circumstances or facts which has or reasonably could be expected to have [a material adverse change] . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] subsidiaries taken as a whole . . ." 789 A.2d at 65.

n5 789 A.2d at 68.

n6 789 A.2d at 67.

n7 789 A.2d at 69.

n8 789 A.2d at 71.

n9 789 A.2d at 67-71.

n10 789 A.2d at 66, 67.

n11 789 A.2d at 68.

n12 2005 *Del. Ch. LEXIS 57* (Del. Ch. Apr. 29, 2005).

n13 2005 *Del. Ch. LEXIS 57* at *88. The merger agreement defined a MAC as "a [material adverse change] with respect to (A) the business, assets and liabilities (taken together), results of operations, conditions (financial or otherwise) or prospects of a party and its subsidiaries on a consolidated basis . . ." Id. at *126.

n14 2005 *Del. Ch. LEXIS 57* at *131 n.218.

n15 2008 *Del. Ch. LEXIS 134* (Del. Ch. Sept. 29, 2008).

n16 2008 *Del. Ch. LEXIS 134* at *52.

n17 2008 *Del. Ch. LEXIS 134* at *53.

n18 2008 *Del. Ch. LEXIS 134* at *52.

n19 2008 *Del. Ch. LEXIS 134* at *65-66.

n20 2008 *Del. Ch. LEXIS 134* at *70-72.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Sam Snider is Vice President and Lead Acquisition Counsel for LexisNexis, a division of Reed Elsevier Inc. He is responsible for all aspects of LexisNexis global mergers, acquisitions, divestitures and restructuring activities, including numerous acquisitions in the United States, Europe and Asia. In addition, he leads the Outsourcing and Offshoring and

U.S. Legal Compliance teams within the LexisNexis legal department. He is a frequent writer and speaker on corporate law and M&A matters and was named a Georgia Rising Star by *Atlanta Magazine* and *Georgia Super Lawyers-Rising Star Edition*.

Rahul Patel is a partner in King & Spalding LLP's Corporate Practice Group, where his practice focuses on mergers and acquisitions and strategic corporate transactions. A significant portion of his practice involves cross-border transactions, particularly transactions involving Indian companies. He is the President of the University of Florida College of Law Alumni Council, serves on the University of Florida Alumni Association Board of Directors, and was recently one of three University of Florida Law School alumni given the inaugural Outstanding Young Alumnus Award. He has also been named a Georgia Rising Star by *Atlanta Magazine* and *Georgia Super Lawyers-Rising Star Edition*.

Will Smoak is an associate in King & Spalding LLP's Corporate Practice Group, where his practice focuses on corporate transactions and general corporate law. He joined King & Spalding in 2007 after completing a clerkship with Vice Chancellor Stephen P. Lamb on the Delaware Court of Chancery in Wilmington. He received his J.D. degree from Duke University School of Law and his Bachelor of Arts in History from Davidson College.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



14 of 19 DOCUMENTS

Emerging Issues Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Aquila and Sawyer on Unsolicited Takeover Offers

2009 Emerging Issues 3287

Frank Aquila and Melissa Sawyer -- Unsolicited Takeover Offers

By Mr. Frank Aquila Esq. and Ms. Melissa Sawyer Esq.

January 19, 2009

SUMMARY: Frank Aquila and Melissa Sawyer provide an overview of how to launch and respond to unsolicited takeover proposals. Among other things, this commentary addresses: (1) Who are the key players; (2) What options do bidders have; (3) What defensive strategies can targets employ; and (4) What role can advisors play.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Unsolicited takeover activity tends to surge in times of economic uncertainty, when stock prices are low, seller price expectations are still high and the markets are volatile. Viewed in the light of an intelligent market, unsolicited takeovers can help to deliver value to shareholders when the public markets are otherwise undervaluing a target, or when the target's management or board is resisting a friendly transaction that could otherwise be in the best interests of the target's shareholders. Unsolicited proposals, however, can also be disruptive to a target's operations and can confuse shareholders about a target's long-term value. The techniques associated with launching and responding to unsolicited takeovers are designed to strike a balance between permitting unsolicited takeovers that would deliver full and fair value, while allowing targets to rebuff proposals that are not in the best interests of their shareholders.

Not every unsolicited takeover ends as a "hostile" deal. Many targets' boards of directors ultimately agree to sell after receiving an unsolicited acquisition proposal. Even when there is an openness to an offer, targets often show some initial resistance to generate a higher "best and final" price for their shareholders. The typical "back and forth" between targets and bidders follows a path that is defined by both legal and strategic considerations. Most potential bidders select from a familiar menu of tactics, and most target companies opt to employ well-developed defensive devices that have been tested repeatedly in practice and in the courts. This article outlines the familiar features of unsolicited takeovers: who are the key players, what options do bidders have, what defensive strategies can targets employ, and what role can advisors play.

Although this article provides an outline of the basic unsolicited takeover tools, knowing the names of the pieces does not a great chess player make. Unsolicited takeovers have not been completely routinized. What makes these deals challenging is that no two companies are alike, and no two markets apply the same pressures on deals. Experienced outside advisors can help to anticipate issues, be proactive and respond creatively in unsolicited takeover situations.

The Usual Suspects

The key players in any unsolicited takeover are the following: (1) the bidder; (2) the target's management; (3) the target's board of directors; (4) the target's shareholders; and (5) regulators.

(1) The Bidder

There are usually only two types of bidders in unsolicited takeovers: (1) strategic bidders and (2) financial bidders. Strategic bidders usually are companies that operate in the same or a related industry as the target. Financial bidders tend to be private equity firms or similar investors who intend to retain existing management and lever up the target's assets. It is critical to "know your customer". Both types of bidders have strengths and weaknesses, including the following:

(a) ***Strategic Bidders.*** Strategic bidders tend to have the following strengths, among others: (1) knowledge about the industry in which the target operates; (2) ability to generate cost and/or revenue synergies from a transaction; (3) overlapping shareholder base; and (4) relationships with management and board members. Strategic bidders tend to have the following weaknesses, among others: (1) multiple constituencies and, in particular, sensitivity to adverse employee, public and regulator opinion; (2) antitrust issues; (3) slower decision-making processes; and (4) in some cases, public company disclosure obligations and attendant pressures to "tell the right story" to analysts and shareholders.

(b) ***Financial Bidders.*** Some, but not all, of the characteristics of financial bidders are "counterpoints" to the strategic bidder characteristics identified above. Financial bidders tend to have the following strengths: (1) streamlined decision-making processes and speed of execution; (2) internal alignment around completing the acquisition; and (3) experience with acquisitions. Financial bidders tend to have the following weaknesses: (1) costs of debt and restrictions imposed by lenders (especially in the current market environment); (2) lack of synergies, operational experience and knowledgeable management; (3) in some cases, inability to use equity awards to retain target employees; and (4) reputation, as financial bidders, for undervaluing the long-term prospects of targets.

As this article outlines below, these characteristics shape a bidder's choices about what tactics to use in an unsolicited takeover. They can also inform a target's defensive efforts, include the target's communication plan.

(2) Target's Management

Target's management is the target's first line of defense in an unsolicited takeover, and they are also usually the target's primary negotiators. It is rare for a bidder to make a public offer without first approaching management or the target's board (who would likely liaise with management to respond to the approach).

In the canon of takeover cases, the target's management often plays the role of ruthless protector of the status quo, preserving their own jobs at the expense of maximizing shareholder value. In reality, the situation is not so clear-cut. Among other reasons management may not be entirely opposed to an unsolicited takeover are the following: (1) many executive compensation packages include "golden parachutes" to ensure management's interests are aligned with the shareholders' in a takeover context; (2) if the bidder is a financial bidder, management may have opportunities for continued employment and a greater equity stake in the surviving company; and (3) the reputational consequences of defying shareholder interests can be severe (as Jerry Yang is well-aware in the wake of Yahoo's rejection of Microsoft's unsolicited takeover bid). Indeed, in some cases it may be necessary for the target's board to act as a check on the target's management's desire to sell.

(3) Target's Board of Directors

The target's board of directors is subject to fiduciary duties defined under applicable state corporate law. The Delaware Chancery Courts have been leaders in developing precepts of fiduciary duties and standards of reviewing director actions in the takeover context. Many other states have imported Delaware doctrines into their business corporation statutes and even more states' courts rely on and refer to Delaware cases in their decisions.

Whether the exercise of fiduciary duties will result in a sale of the target depends on numerous fact-specific criteria. A review of *Revlon*, *Unocal*, *Unitrin* and other classic Delaware takeover cases is beyond the scope of this article, and in any event the detailed fiduciary duties applicable to any given board vary by state and by transaction structure. In any takeover of a U.S. corporation, however, it is possible to generalize two critical requirements for the target's directors: (1) they must not promote a transaction in which they have a personal stake (other than the vesting of their equity awards in line with other employees' awards) without disclosing their interests to the rest of the board; and (2) they must act with due care. These are not platitudes: In advising a board of directors, returning to these key principles can help to generate a record that will withstand the painful scrutiny of 20/20 hindsight in derivative or shareholder class action litigation.

Over the past decade, public company boards have become more professionalized, more experienced with takeovers, more diverse and more active. These changes have resulted from, among other things, the imposition of stock exchange and Sarbanes-Oxley independence and audit committee "financial expert" requirements, the prevalence of plaintiffs litigation, scrutiny of board action by shareholder and corporate governance services and the detailed requirements of the proxy disclosure rules. As a consequence of these developments, in connection with an unsolicited takeover, a target's board is likely to expect to receive written analyses at board meetings, involvement by outside legal counsel and financial advisors, and multiple opportunities for detailed questions and discussion.

(4) Target's Shareholders

Typically, within 24-36 hours of the public announcement of an unsolicited proposal, a target's shareholder base will change dramatically. The target's shares will flow into the open arms of arbitrageurs, hedge funds and other "short-term" holders who hope to make money by placing bets on the outcome of the unsolicited proposal. A bidder may postpone making a public announcement of its proposal, however, in the hope of avoiding a bidding war or stimulating higher market prices based on the expectancy of a takeover. Before an unsolicited proposal becomes public, one of the target's first questions should be "who's in my shareholder base today and what are their goals?" The shareholder base could include the bidder, retail holders, employees and insiders, institutional holders, activists, arbitrageurs and others. Knowing the pre-announcement composition of these shareholder base will help the target to assess its vulnerability to an unsolicited proposal.

If the bidder has acquired over 5% of the target's shares, the bidder could become subject to a Schedule 13D beneficial ownership reporting obligation. The bidder could also trip other filing requirements at varying ownership levels depending on the industry and size of the deal (e.g., Hart-Scott-Rodino, Change in Bank Control Act, Exon-Florio, insurance regulatory filing requirements). If the bidder is below 5%, however, it can be difficult to trace whether the bidder owns shares of the target. A search of the target's transfer agent's records will only reveal the names of shareholders of record; it will not reveal the names of holders who hold in street name or derivative positions. Proxy solicitors on occasion have access to Cede lists, surveys and other non-public information that can help identify shareholders.

Retail holders are traditional "mom and pop" shareholders. Their reaction to an unsolicited offer can be difficult to gauge because they do not speak with a single voice and they can be slow to respond to market developments.

Employees and other insiders tend to be pro-management in unsolicited takeovers. It can be easier for a target to contact these holders and solicit support for a transaction, whether through word of mouth or through tools like internal websites, town hall meetings and other forms of communication.

Activist shareholders, often a source of unsolicited takeover activity, include hedge funds (like Relational Investors) and wealthy individual investors (like Carl Icahn and Nelson Peltz). Often, activists are looking for ways to increase the short term value of the target's shares (sometimes at the expense of long-term strategic plans). In some cases, rather than making a proposal to acquire a target out-right, they will seek a few board seats and seek management shake-ups or strategic changes (such as divestitures of underperforming business lines). On occasion, they will publicize

not just their acquisition proposals but long lists of complaints and suggestions (e.g., in the form of a "white paper"). Activists have become increasingly sophisticated and attuned to opportunities to effect change through traditional corporate governance mechanics, like shareholder proposals, withhold vote campaigns, binding bylaw amendments, director elections, litigation and public relations campaigns.

Arbitrageurs (or "arbs", as they are known colloquially) are a subset of hedge funds. They tend to be more opportunistic, expending fewer resources on first-hand involvement and instead placing bets on the outcome of an unsolicited takeover process launched by somebody else. They frequently flood into a target's stock after the announcement of an unsolicited proposal, sometimes using derivatives like total return swaps. They make bets on the outcome of a deal and often trigger immediate fluctuations in a target's stock price. For example, if the arbs move into a stock and the stock price rises above the announced proposal price, the arbs are signaling that they believe the deal will be completed after the bidder raises its price. Arbs can also include short-sellers, who may be betting against a successful transaction.

One reason that hedge funds and arbs have so much influence is the "wolf pack" phenomenon. When one holder surfaces and informs the market how they plan to react to an unsolicited takeover, the rest of the pack follows. When a hedge fund surfaces, it often puts the target company "in play", with competitors and private equity funds lining up to be the proverbial "white knight".

Institutional holders often follow voting recommendations of outside institutional investment advisors like Risk Metrics (formerly ISS) or Glass Lewis. Historically, these services have tended to be pro-takeover and anti-deal protection, supporting the proposals initiated by hedge fund and other activist shareholders. Among other things, Risk Metrics advocates withholding votes from directors who ignored a shareholder proposal that was approved by a majority of the votes cast for two consecutive years, ignored a shareholder proposal approved by a majority of the shares outstanding, or adopted or renewed a poison pill since the last annual meeting without a requirement to put the pill to a shareholder vote within 12 months of its adoption. It is unclear whether Risk Metrics will continue to support shareholder activists as consistently in the current economic environment as they have in the past. A target that has a good "strategic value" story may find a greater foothold with Risk Metrics now than in the past. In any sizeable deal, a target's communications strategy should consider whether meeting with any of these services is likely to be helpful.

(5) Regulators and Politicians

Regulators can have a material impact on the outcome of an unsolicited transaction. For that reason, it is critical to understand both the target's and the bidder's relationships with their regulators. It goes without saying that parties frequently seek to involve the U.S. Securities and Exchange Commission ("SEC") in unsolicited takeovers, through the submission of bed-bug letters and through the use of SEC filings as part of their overall communications plan. The SEC is not the only relevant regulator, however. For example, the federal government is widely regarded as having been a matchmaker in certain recent banking transactions, and the antitrust regulator's willingness to turn a blind eye to, or to investigate, a merger can determine whether and when a transaction can close. The U.S. government's Exon-Florio review process can also deter non-U.S. bidders. Parties seeking to promote or defend a takeover should consider whether to retain a lobbyist or otherwise seek to apply regulatory or political pressure to influence the outcome of the transaction.

Enemy at the Gates

Bidders have a variety of options for approaching the target, with varying amounts of complexity, hostility and publicity. Here, we outline the most frequently-used methods, from least aggressive to most aggressive.

(1) Casual Pass

The least aggressive approach to a target by a bidder is the "casual pass". Usually this involves a senior executive from the bidder approaching a senior executive or director of the target on an informal basis (such as at an industry

conference or social event) and indicating a desire to discuss a transaction. The advantage of this method is that the bidder can often get an early read on whether there is any room to negotiate a deal from how the target reacts to the proposal. The disadvantage is that this method lets the "cat out of the bag" on the bidder's plan, giving the target a chance to start implementing a communications plan and defensive measures that could ultimately make it more difficult for the bidder to succeed.

(2) Bear Hugs

The bidder's next more aggressive option, which can be used as the first step or following a casual pass, is to send the target a formal proposal for a transaction. This proposal is usually called a "bear hug letter". These letters range in aggressiveness from "grizzly bear hugs" (public letters containing firm price proposals) to "teddy-bear hugs" (non-public letters that may or may not contain a firm price proposal). If the bidder makes the letter public, the letter may recite a litany of criticisms concerning the target's management team or strategic direction. If non-public, the letter will often indicate a desire to sign a friendly transaction.

(3) Stock Purchases

A bidder can accumulate a stake in the target company through open market or privately negotiated purchases. This stake will provide a base from which the bidder can launch an unsolicited tender offer or proxy contest. The bidder will be required to disclose the existence of its stake in a public company if it trips the 5% Schedule 13D beneficial ownership reporting threshold. The bidder may also be required to make a Hart-Scott-Rodino Act premerger notification filing if the value of the shares accumulated exceeds \$63.1 million (at current 2008 thresholds). A bidder's accumulations will also be subject to the target's poison pill restrictions and any state law restrictions under interested shareholder statutes or control share acquisition statutes, if any. Recently, bidders have used derivatives (like cash settled swaps) initially to hide their true ownership positions from the target and the market, and to avoid triggering certain disclosure thresholds. Bidders must exercise caution in entering into arrangements with other beneficial owners of the target's shares so as not to trip any reporting obligations inadvertently.

(4) Tender/Exchange Offers

If the bidder has attempted any of the foregoing options unsuccessfully or otherwise wants to be more aggressive at the outset, the bidder may seek to launch a tender or exchange offer. A tender or exchange offer is an offer made directly to the target's shareholders, usually at a premium to the target's market price to put pressure on the target's board. An exchange offer is more difficult to use in a hostile context due to the need to register the bidder's shares with the SEC and the uncertainty generated by fluctuating share values. A cash tender offer can close in 20 business days (absent any need for regulatory approvals or substantive antitrust issues), unless the target's board has taken defensive measures (like implementing a poison pill).

Recent changes to the tender offer rules have made the use of tender and exchange offers in connection with unsolicited proposals more feasible. Among other things, the SEC clarified the best price rule to more clearly exclude consideration payable to employees under benefit and option plans. In addition, the SEC recently issued new rules relating to cross-border tender offers that facilitate the making of tender offers by non-U.S. parties without complying with the full range of U.S. tender offer requirements.

(5) Proxy Contests.

A proxy contest is generally aimed at seeking to replace existing directors with a dissident slate and/or seeking the adoption of other shareholder proposals. Usually the purpose of the proxy contest is to facilitate an offer (e.g., by taking control of a majority of the board, a bidder may be able to eliminate the impact of the target's poison pill on the bidder's offer). A target's structural defenses in its articles and bylaws usually influence the extent to which a proxy contest will be successful. Factors such as the existence of a classified board, cumulative voting, shareholders' rights to call special meetings, shareholders' rights to remove directors without consent, shareholders' rights to make proposals, etc., all

regulate the process and prospects for success of the bidder's strategy.

(6) Other Alternatives

Finally, a bidder may seek other profit alternatives short of a full takeover attempt. These strategies, which are especially favored by activist hedge funds, could include advocating publicly for the target to repurchase shares, restructure or spin-off underperforming business lines, recapitalize or declare an extraordinary dividend, or effect a sale to a white knight. A bidder might pursue any of these strategies by making public "reform" proposals and seeking to persuade management and the board to take the bidder's advice.

In addition to the strategies described above, there are numerous other actions that a bidder can take in connection with a potential unsolicited proposal. A bidder can, within the limits of the beneficial ownership reporting rules, encourage hedge funds and other activists to become shareholders, interview customers, shareholders and line management, question the target's management aggressively on analyst calls, leak ideas to the research analyst community, hire former employees and commence litigation against the target, to name a few.

The Empire Strikes Back

A target that becomes the subject of an unsolicited proposal has a number of options at its disposal. It goes without saying that a target's best defense to an unsolicited proposal is to have a strong stock price. Additional protection can come from addressing other "vulnerability" factors, such as recent changes in top management that attract attention and create uncertainty in the market, recent equity offerings that dilute "friendly" control blocks' highly concentrated stock ownership, the existence of high cash or regulatory capital balances, poor corporate governance, underperforming business units that are unrelated to the target's core business, and small market capitalization that will not deter a motivated bidder.

If a target becomes unavoidably vulnerable to an unsolicited proposal, the target will need to have a strategy for maximizing shareholder value notwithstanding its vulnerability. Set forth below is an overview of various strategies targets can use to maximize their value. None of these strategies will filibuster an attractive takeover indefinitely, but they can buy the target some time to seek other, more beneficial alternatives or to negotiate with the bidder to obtain a higher price.

(1) Preparation

Once a target finds itself vulnerable to an unsolicited takeover, a target's best defense is preparation. Before responding to any unsolicited approach, the target's directors should understand their fiduciary duties as directors, understand the target's defensive posture, be familiar with the target's strategic plans, and consider the target's financial and strategic alternatives (including continued independence). The target's board and management also should become familiar with any change in control restrictions in the target's financing documents and other material contracts. The target also should take stock of its director and officer insurance coverage and indemnity provisions to ensure they are up-to-date and consistent with applicable law.

When confronted with an unsolicited proposal, the key question for any target is: "Is now the right time to sell?" The target's board and management must be aligned on the "message" in response to any third party approach. The target should assemble a team of outside advisors (financial advisors, legal advisors, a public relations firm and a proxy firm). The target should open lines of communication with its shareholder base (keeping in mind the limitations of Regulation FD, which applies to any material non-public information shared with a shareholder unless the shareholder expressly agrees not to disclose the information and not to trade on the basis of it). It should analyze potential bidders, monitor stock trading activity, and establish a no-comment policy. Directors also should become familiar with, and should observe, the target's policies on trading in its own securities. Finally, the target should analyze its benefit plans to ensure that they are up-to-date and contemplate the possibility of a change in control.

(2) Just Say No; One-Voice Policy

If the bidder merely makes a casual pass at the target, the target has no duty to discuss or negotiate the bidder's proposal. A target's final response to an offer will depend on the terms and conditions of the offer. Among other things, the target's board should evaluate the regulatory conditions and financing conditions associated with the offer, and assess the strategic and financial characteristics of the raider. The target's board may seek a fairness opinion from its financial advisors as to the adequacy of the consideration offered. In practice, a pure "just say no" defense, while legal, is rare absent substantial shareholder support (*e.g.*, Taubman), a weak bidder (*e.g.*, ArvinMeritor/Dana) or regulatory issues (*e.g.*, Oracle/PeopleSoft).

The target that uses the "just say no" policy has no duty to disclose the existence of a proposal unless the target itself is the source of a leak about the proposal, the target needs to correct a prior misstatement, the target is in registration, or the target is trading in its own stock. To avoid generating leaks or making statements that later need to be corrected, it is critical for a target to adhere strictly to a "one voice" policy. A single individual (usually the chairman or CEO) should be the sole source of comments regarding unsolicited proposals, both publicly and vis-~~agrave~~-vis the bidder. If approached, directors should clearly state they are not authorized to speak for the target, direct the third party to the chairman CEO, and immediately inform the chairman and the CEO of any expressions of interest from any third party. The chairman and CEO should be prepared with a script of responses, ranging from a firm "no" to a more friendly invitation to continue further discussions at a later time when the stock is less depressed.

(3) Monitoring the Stockholder Base

If the target suspects that a potential bidder is making open market purchases, the target should monitor trading in its securities. It can do this by asking its transfer agent to notify it, if any one record holder accumulates more than 1% of its shares. It can also retain a proxy solicitor to monitor activity in the shares. The target also should monitor Schedule 13D filings and Hart-Scott-Rodino filings (although these generally will not disclose derivative positions). The target may also use its proxy solicitor and financial advisor to do stock price/volume analyses and may try to leverage contacts with specialists/market makers on its exchange to extract information about stock movements.

(4) Standstills

If a target receives a bear hug letter, the target should promptly call a board meeting to consider the bidder's proposal. Generally, no public statement or press release is required. The target should consider whether to meet with the bidder, keeping in mind that a flat refusal to meet could be viewed as a negative by certain shareholders. If the target agrees to meet with the bidder, the target should request that the bidder enter into a standstill agreement (perhaps in exchange for entering into a confidentiality agreement and giving the bidder access to non-public information). Some bidders will refuse to sign a standstill agreement that restricts them from proceeding on an unsolicited basis.

(5) Responding to a Tender Offer

If the target becomes the subject of an unsolicited tender or exchange offer, the target will need to disclose its board's recommendation (or lack thereof) with respect to the offer on a Schedule 14D-9 within 10 business days of commencement of the offer. Among other things, a Schedule 14D-9 must include details of negotiations with third parties (but no names are required to be disclosed) and may include a banker's fairness or inadequacy opinion. The Schedule 14D-9 gives the target a critical opportunity to tell its side of the story in response to an opportunistic takeover proposal.

(6) Responding to a Proxy Contest

If a bidder launches a proxy contest, a target should promptly retain a proxy solicitor and a public relations firm and work to get its own message out to shareholders and institutional shareholder services like Risk Metrics. Obviously a target (and the bidder) must comply with all applicable proxy rules. Advance notice requirements in the target's

bylaws are important for ensuring that the target has adequate time to respond to a bidder's proxy contest. Numerous corporations have also adopted, as part of their advance notice bylaws, requirements that a shareholder seeking to nominate directors or make a shareholder proposal must also provide notice of its and its director nominees' economic and voting interests in the target (whether through investments in equity securities, derivatives, debt securities or other transactions). Having this information can help a target to assess the extent to which a bidder's economic interests are actually aligned with the interests of other, disinterested shareholders.

(7) Other Profit Alternatives

Like a proxy contest, if the bidder's strategy involves making proposals to force other profit alternatives, the target would be well-advised to retain a public relations firm and proxy solicitor. The target should also evaluate its strategic plans and develop a response to the bidder's specific proposals. In some cases, the target may determine to undertake proactive restructuring steps to create near-term value for its shareholders. These steps could include a leveraged share repurchase, an extraordinary dividend, an equity placement with a white squire or employee stock option plan, acquisitions, divestitures, spin-offs and recapitalizations. The target may also consider other third party alternatives, including a strategic combination with a white knight, a leveraged buy-out or an auction process.

(8) Structural Takeover Defenses

Structural defenses are generally only possible if there has been careful advance preparation by the target. Adopting structural takeover defenses can cause institutional shareholders to react negatively and they generally are not effective against cash tender offers at a premium.

A target's key structural defenses include a prohibition on the shareholders' ability to act by written consent (which denies a hostile raider the ability to remove and replace directors fairly quickly and without a meeting of shareholders) and their ability to call a special meeting (which confines all business to the annual meeting, limiting a board's "window of vulnerability" to a proxy contest to one meeting per year); restrictions on the ability to remove directors without cause; classified boards (to limit the number of directors elected in any given year); limits on the number of directors (to prevent dissident shareholders from causing the removal of a director for any reason other than fraud, criminal acts, etc.); limitations on the right of shareholder to fill board vacancies (to prevent dissident shareholders from "packing" the board by filling vacant seats); allowing the board to amend bylaws (to allow the board flexibility to modify defenses as needed); requiring a supermajority vote to amend certain bylaw provisions (to limit the rights of shareholders to change the target's governing documents so as to facilitate a takeover); prohibitions on the ability to put forward shareholder proposals or to nominate directors at shareholder meetings without advance notice to the target (to limit the use of "last minute" proposals and give the board advance notice of any dissent); flexibility in setting the annual meeting (to grant the board flexibility to determine the best time to schedule an annual meeting, subject to state law requirements); and blank check preferred stock (to allow the board to implement a poison pill); among others. A detailed discussion of each of these defenses is beyond the scope of this article but there is substantial literature available describing the pros and cons of each of these.

All of the above defenses must be adopted in accordance with state law. For example, under Delaware law, a prohibition on the shareholders' ability to act by written consent must be contained in the charter. If certain prohibitions only appear in the bylaws, they may be unenforceable or susceptible to amendment by the dissident shareholder. Defenses contained in the charter may not be amended unilaterally by the board.

(9) Poison Pills

The poison pill (or shareholder rights plan) has been used as a defense in virtually every significant hostile bid for a widely held company in recent years. It is not, however, intended to and will not prevent a hostile takeover of a company, nor does it eliminate the obligation of directors to exercise their fiduciary duties. Its role is to give the board more time to evaluate alternatives in order to maximize shareholder value. A target's board can usually implement a

poison pill quickly without a shareholder vote, knowing that it has been endorsed by the courts in most states. The board retains the power to redeem the pill if it decides to approve an offer. This encourages hostile bidders to negotiate with the board (because they cannot complete an acquisition until rights are redeemed).

At its core, a poison pill involves issuing rights that trade with the target's common stock until the rights are "triggered". The rights only get triggered if a shareholder goes over a specified ownership threshold (typically 15%). If triggered, the rights would massively dilute both the value and percentage of the triggering bidder's equity investment. The actual impact is largely theoretical (no one has ever completely triggered a pill), but pills continue to operate as an effective deterrent in most circumstances.

In the early part of this decade, many corporations eliminated their poison pills in response to shareholder activists. Indeed, S&P 500 companies had 61% fewer poison pills in 2007 than they did in 2001. Companies that retained their pills in some cases adopted "shareholder friendly" features, including requiring oversight by independent directors, sunset provisions and "chewable" pills. Companies considering adopting or extending rights plans should consider their investors' reactions, whether to adopt any of the foregoing features, and whether to evaluate the triggering thresholds given concentration in ownership of their shares. Some of the newer rights plans get triggered upon purchases of derivatives (*see, e.g.*, Microtel's poison pill), but it is unclear whether this feature is really necessary when the conversion of the derivatives into voting shares itself would trigger the pill before the holder could take any adverse action.

(10) State Antitakeover Laws; State Laws Regarding Fiduciary Duties

In addition to defenses contained in the target's organizational documents or poison pill, certain states have adopted statutes that provide additional defenses. These may include fair price statutes, constituency provisions, control share acquisition statutes and interested shareholder statutes.

A detailed discussion of the duties of a board of directors in adopting takeover defenses and deal protection measures is beyond the scope of this article. These duties vary from state to state and tend to be highly context dependent. As with other aspects of responding to an unsolicited proposal, a target's board should seek the advice of knowledgeable outside counsel in connection with these matters.

A Few Good Men

Ultimately, shareholders drive deals. A good offer at a good price will be hard for any target to resist. That being said, there still is an important role for strategy in making and responding to unsolicited proposals. The parties' strategic choices can impact how quickly the deal gets done, and at what cost. Involving experienced advisors early in the process can help both bidders and targets to avoid mis-steps that impede their future strategic choices. Both parties should involve legal counsel, a public relations firm and a proxy solicitor. The target also should involve a financial advisor.

The parties' legal teams may include deal counsel, local counsel, in-house lawyers and regulatory lawyers. Outside legal counsel can help to analyze the target's legal defenses and advise its client about the disclosure and other legal requirements associated with responding to unsolicited proposals. Legal counsel can also advise about litigation defense, regulatory issues, fiduciary duties, executive compensation issues and the use of defensive measures and deal protections. Experienced legal counsel also will play an important role in coordinating strategy with the rest of their client's team of outside advisors.

A public relations firm will prepare a detailed analysis of communications issues and concerns and develop messaging and documentation. They will prepare a detailed announcement timetable and rollout schedule, arrange all logistics associated with public announcements and manage leaks. The public relations firm also will prepare and coach senior spokespeople and handle media, investor and employee relations. This may include conducting a risk analysis to understand, anticipate and neutralize opposition arguments. A public relations firm can also manage communications of

regulatory/antitrust concerns. In retaining a public relations firm, the target/bidder should ensure the candidate firm has substantial experience with unsolicited takeovers and, if the transaction will have non-U.S. aspects, should make sure the firm has experience with cross-border transactions.

A proxy solicitor will monitor movements in the target's stock and help its client to anticipate how certain groups of shareholders (*e.g.*, mutual funds, employee plans, retail holders and large individual holders) will react to certain announcements. Working with the public relations firm, the proxy solicitor will help to craft shareholder communications that will target each relevant group of shareholders. In many cases, a proxy solicitor will be familiar with a bidder's "M.O." and will be able to advise a target on what to expect once a bidder has announced its intentions. The proxy solicitor may also act as an information agent in a tender offer or proxy contest, assisting the target to respond to shareholder inquiries and requests for copies of tender offer materials.

A financial advisor will maintain up-to-date analyses of the target's off-balance sheet values, and prepare comparisons of potential takeover values with recapitalization, spin-off and other alternatives. The target's board may want its financial advisor to give it an opinion as to the fairness of a proposed transaction. In many cases, the opinion will be based in part on the projections provided to the financial advisor by management, and the financial advisor will assume those projections are attainable. Nevertheless, it is often a useful "check" on the management forecasting process to have an "independent" third party reviewing and discussing management's projections.

Other types of advisors may play a role on particular transactions. For example, lobbyists can smooth the path for a non-U.S. bidder seeking to acquire a U.S. company in certain industries, and specialist actuaries, tax consultants, accountants and other advisors may also be necessary to assist with due diligence and structuring the transaction.

Conclusion

The terminology used to describe unsolicited proposals often paints bidders in a pejorative light, painting them as "opportunistic raiders" and labeling them "hostile". In practice, unsolicited proposals can generate attractive value for target shareholders and lead to corporate governance and other reforms. As Gordon Gecko said, in representing the role of a "raider", "I am not a destroyer of companies, I am a liberator of them." That being said, targets have to analyze whether a sale will generate more value than the target's stand-alone prospects. There certainly are times when a target's low stock price may not reflect its fundamental value due to market conditions. If the target's board does decide to sell the company, they should try to extract as much value as possible from potential buyers. The techniques outlined in this article are all designed to help a bidder get its foot in the door, and to help a target protect itself and its shareholders from undesirable proposals.

For more on mergers and acquisitions, see M&A Practice Guide (LexisNexis Matthew Bender) and Corporate Acquisitions and Mergers (Matthew Bender). See also the LexisNexis M&A Practice center on Lexis.com.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ABOUT THE AUTHOR(S):

Frank Aquila is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. His practice focuses on mergers, acquisitions, strategic alliances and corporate governance matters for large multinational corporations. Mr. Aquila was lead outside counsel to InBev in connection with its successful unsolicited acquisition of Anheuser-Busch. Mr. Aquila received a Burton Award for Legal Achievement in 2005. He received his A.B. degree from Columbia University and his J.D. degree from Brooklyn Law School.

Melissa Sawyer is a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group. Her practice has focused on a variety of corporate, M&A and private equity matters in the U.S. and abroad. Ms. Sawyer was featured in

"The Facebook of Wall Street's Future" (New York Times, October 3, 2007) as one of Wall Street's "next generation of deal makers." She received her B.A. degree from Washington & Lee University and her J.D. degree from the University of Virginia Law School.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



15 of 19 DOCUMENTS

Emerging Issues Copyright 2009, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Snider, Miles & Belenky on Unocal and Unitrin

2008 Emerging Issues 3041

R. Samuel Snider, Rachel A. Miles and Erik L. Belenky on Unocal Corp. v. Mesa Petroleum Co. and Unitrin, Inc. et al. v. American General Corp.

By Mr. R. Samuel Snider Esq., Ms. Rachel A. Miles Esq. and Mr. Erik L. Belenky Esq.

October 19, 2008

SUMMARY: The business judgment rule is utilized by Delaware courts to evaluate board actions when there is no indication of a conflict of interest. The directors are presumed to have satisfied their fiduciary duties of care and loyalty. In transactions that involve an actual conflict of interest affecting a majority of the board, Delaware courts apply a more exacting standard -- the "entire fairness" test.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: In Delaware, courts evaluate actions of board of directors under one of three standards of review: the business judgment rule; "entire fairness"; and so-called "enhanced scrutiny." The business judgment rule is utilized by Delaware courts to evaluate board actions when there is no indication of a conflict of interest between board members and the corporation or its shareholders. Under the business judgment rule, board actions are "presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" n1 i.e., the directors are entitled to a presumption that they satisfied their fiduciary duties of care and loyalty. In transactions that involve an actual conflict of interest affecting a majority of the board, however, Delaware courts apply the exacting "entire fairness" test. This involves a judicial review of the process employed by the board as well as a substantive determination regarding whether the transaction was entirely fair to the company's stockholders. n2

In *Unocal Corp. v. Mesa Petroleum Co.*, n3 the Delaware Supreme Court recognized that when addressing a pending takeover bid, although there may not be evidence of a direct conflict of interest, the "omnipresent specter that a board may be acting primarily in its own interests" n4 gives rise to "an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." n5 After recognizing that certain situations (in the case of *Unocal*, a takeover bid) create, by their very nature, a structural possibility of a conflict of interest, the *Unocal* court then articulated an intermediate level of scrutiny between the business judgment rule and the entire fairness standard that allows courts to evaluate board actions without the presumption that the board acted in good faith or the converse presumption that the board was incapable of acting in an unbiased manner. The *Unocal* courts new "enhanced scrutiny" standard provided that when taking defensive actions in response to an unsolicited offer, a board must be able to show that (1) it had a reasonable basis to believe that there was a threat to its corporation's policy or control, and (2) the defensive measures selected were reasonably proportional to the threat posed. If the board meets this burden of proof, then its decision regarding the defensive measures will be

accorded the protections of the business judgment rule. Ten years later, in *Unitrin, Inc. v. American General Corp.*,ⁿ⁶ the Delaware Supreme Court expanded the second prong (proportionality) of the *Unocal* test to examine (i) whether the defensive measures were preclusive or coercive, and (ii) if not, whether the defensive measures fall within a range of reasonableness.

Unocal involved Mesa Petroleum Co.'s unsolicited attempt to acquire majority control of Unocal through a two-tiered, front-loaded offer for Unocal's outstanding stock.ⁿ⁷ Mesa's bid was structured as follows: first, there would be a cash tender offer for 37% of Unocal's outstanding stock at a purchase price of \$54 per share; and second, the stockholders that failed to tender in the first round would be forced to exchange their Unocal stock in the second round for highly subordinated securities that Unocal labeled as "junk bonds".

Unocal's board of directors, which consisted of a majority of independent directors, met to analyze Mesa Petroleum's offer. During the meeting, both Unocal's legal counsel and financial advisors made presentations regarding the board's legal obligations and the financial advisors' opinion that Mesa Petroleum's proposal was economically inadequate, valuing Unocal's stock at more than \$60 per share. Additionally, Unocal's financial advisors, Goldman Sachs, explained different defensive measures that the board could take in response to Mesa Petroleum's offer, including Unocal conducting a self-tender for its stock within a price range of \$70 to \$75 for each share. Even though this proposal would require Unocal to incur \$6.1 to \$6.5 billion in additional debt, Goldman Sachs advised that such debt was manageable for the corporation.

The outside directors met separately and unanimously voted to approve implementing a self-tender. The entire board then met and passed a resolution rejecting Mesa Petroleum's offer. Two days later, the board reconvened to further discuss the possibility of a self-tender, and the board voted unanimously to approve the self-tender subject to the following conditions: (i) the self-tender would not be triggered until Mesa Petroleum acquired a certain level of stock through its cash tender offer; and (ii) Mesa Petroleum would be excluded from the offer.

Mesa Petroleum filed suit in the Delaware Court of Chancery to challenge Unocal's selective exchange offer. The Chancery Court held that an exchange offer that treated certain stockholders unfairly was impermissible and issued a temporary restraining order to prevent Unocal from completing its offer. Unocal appealed the injunction to the Delaware Supreme Court, and the Delaware Supreme Court agreed to hear the case but determined that it would rely on the Chancery Court's determination of certain facts regarding the board's duty, its actions and the applicable standards of review. The Chancery Court's findings included that (i) the board's duty to protect the corporate enterprise extends to threats from stockholders, (ii) Unocal's board had acted in good faith based on its belief that Mesa Petroleum's offer was inadequate, and (iii) the business judgment rule does not apply to a selective exchange offer.

The Delaware Supreme Court first addressed Unocal's board's exclusion of Mesa Petroleum from Unocal's self-tender offer. The Court held that even though Unocal's exchange offer was a form of selective treatment that discriminated against Mesa Petroleum's stockholders, it was permissible for the board to take such action so long as the board was not acting exclusively to entrench its directors.

Next, the Delaware Supreme Court addressed the applicable standard of review. The Court explained that, in the context of an unsolicited takeover bid, the board faces a potential conflict between protecting its own interests and protecting those interests of the corporation and the corporation's stockholders. As such, the board's actions should be subject to an enhanced level of scrutiny as a threshold test before being afforded the protections of the business judgment rule.

The Court then articulated the contours of the enhanced scrutiny review. Enhanced scrutiny would require the board to meet its own initial two-part burden. First, the board must show that it had reasonable grounds for its belief that a threat existed to corporate control or policy. The Court held that this determination would be made based on the board's showing of good faith and having conducted a reasonable investigation. Though the Court failed to fully define how a board could show that it acted in good faith and conducted a reasonable investigation, it stated that an

independent board would bolster such an argument.

Second, the board must show that the defensive measures selected by the board were reasonable and proportionate in relation to the threat posed. Since a potential conflict of interest is inherent in the context of a threatened change of control, a board's discretion must be limited in how it can respond to such a threat. The defensive measures selected must be proportionately balanced with the threat posed. The Court listed several factors that could be considered in evaluating the second prong of the test, including whether the price offered was adequate, the timing of the offer, what legal considerations the offer calls into play, the possibility that the transaction will not be completed and the type of securities offered. If both prongs of the test are satisfied, then the board's actions are entitled to the protections of the business judgment rule.

With respect to the first prong of the enhanced scrutiny review, the Court held that the facts supported the board's perception that a reasonable threat existed to corporate control or policy. The board had a reasonable basis for its valuation of Unocal's shares at more than Mesa Petroleum's offered purchase price of \$54. In addition, the Court recognized that the two-tiered offer was a coercive device used to "stampede shareholders" n8 into submitting their shares despite the inadequate price offered in the first round to avoid being subject to a lower price in the second round. Lastly, the board presented evidence that Mesa Petroleum was a serial "greenmailer" n9 that had profited by attempting to takeover companies and forcing the target companies to buy out their stock at a higher price to Mesa Petroleum's financial benefit.

With respect to the second prong, the Court held that the self-tender and the exclusion of Mesa Petroleum as a stockholder were reasonable in relation to the perceived threat. The board adopted the selective exchange offer in an attempt to defeat Mesa Petroleum's coercive and inadequate offer. If Mesa Petroleum would not have been excluded from Unocal's self-tender offer, the self-tender would have resulted in Unocal funding Mesa Petroleum's effort to buy the shares at an inadequate price.

Since the board's conduct satisfied both prongs of the enhanced scrutiny test, the Court then held that the board's actions were entitled to the deference accorded under the business judgment rule, and based on the Court of Chancery's previous determination that the board acted in good faith, the Court reversed the Chancery Court and vacated the preliminary injunction.

Ten years later in *Unitrin*, n10 the Delaware Supreme Court further developed the *Unocal* test.

Unitrin involved American General Corporation's unsolicited bid to acquire Unitrin, Inc., a home service insurance provider. American General made a cash tender offer for all of Unitrin's outstanding common stock at a price representing a 30% premium. Morgan, Stanley & Co. counseled the board that the proposal was financially inadequate. Unitrin's legal counsel advised that the proposal might also present antitrust concerns. The board unanimously rejected the proposal as inadequate and then discussed with its financial and legal advisors potential defensive responses. The board voted to add a sixty-day notice provision to its bylaws and approved a stockholder rights plan that would be triggered if a single stockholder acquired at least 15% ownership in Unitrin. At a later meeting, the board adopted a repurchase plan to acquire up to 10 million of its shares at then-current market price as an additional defensive measure.

The board issued a press release explaining its response to American General's offer, including that (1) the American General offer price failed to reflect the "long term business prospects" n11 of Unitrin or the inherent value of its stock, (2) Unitrin's current stock price did not reflect strategic opportunities available to Unitrin, (3) the merger could have antitrust implications and was therefore not certain of closing and (4) the board had adopted a stockholder rights plan to prevent such takeover attempts.

American General filed suit in the Delaware Court of Chancery to enjoin Unitrin from implementing the repurchase plan. Applying the *Unocal* test, the Chancery Court held that the board had properly perceived a threat to Unitrin based on the inadequate price offered. The Chancery Court also found that the stockholder rights plan was a reasonable

response in relation to the perceived threat, as it provided a means to force American General to increase its bid to a level that the board believed to more adequately reflect the value of Unitrin.

However, the Chancery Court held that Unitrins repurchase plan was a disproportionate response to the threat posed by American Generals bid. Since Unitrin had a supermajority voting provision in its Certificate of Incorporation that barred any business combination with a stockholder holding more than 15% of the company unless it had been approved by a majority of the continuing directors or by a 75% stockholder vote, the Chancery Court held that the repurchase plan which would increase the board members collective ownership from 23% to more than 25% of Unitrins stock would "chill" all proxy contests. The Chancery Court concluded that the repurchase plan was more defensive than "necessary", as the stockholder rights plan already served to protect the stockholders from American Generals inadequate offer. Finding that the repurchase plan was disproportionate to the threat posed, the Chancery Court preliminarily enjoined Unitrin from repurchasing the shares of its stock.

Upon accepting Unitrins interlocutory appeal, the Delaware Supreme Court reversed the Court of Chancery, holding that the Chancery Court had misapplied the *Unocal* test and placed too heavy a burden on the directors to justify defensive conduct. Specifically, the Delaware Supreme Court ruled that the Chancery Court had applied an incorrect standard of review by looking at whether the repurchase program was a "necessary" defensive response. Then, the Court focused on the second prong of *Unocal* (the proportionality test) and held that, in applying *Unocal*, a court must engage in a two-step process: first, the court should determine whether the defensive measure was coercive or preclusive; and second, if the measure was not coercive or preclusive, the court should determine if the measure falls within a "range of reasonableness".

The Delaware Supreme Court defines a defensive measure as being "coercive if it is aimed at forcing upon stockholders a management-sponsored alternative to a hostile offer" or if it has "the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of the transaction." A defensive measure is "preclusive if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests."

In analyzing whether Unitrins repurchase plan was preclusive or coercive, the Delaware Supreme Court remanded the case to the Chancery Court ordering it to make the factual findings of whether the plan simply made it more difficult for American General to wage a proxy contest or if it made a proxy contest completely unachievable. If the Chancery Court determined that the repurchase plan was not preclusive, then its final question would be whether the plan fell within a "range of reasonableness". To make this decision, the Delaware Supreme Court advised the Chancery Court to consider whether (1) the decision was authorized under Delaware law as one that could be made in contexts outside of that of a takeover, (2) whether the defensive measure was limited and proportional to the threat, and (3) the boards decision took into account that stockholders varying interests and provided the stockholders with the right to cash-out if so desired.

The *Unocal* court established an intermediate level of review of directors actions in the context of a hostile takeover. In many ways, the "enhanced scrutiny" standard established by the *Unocal* court was a recognition that as corporate dealmakers and financial investors became more sophisticated, boards of directors faced increasingly complex threats to corporate control that, although giving rise to inherent potential conflicts of interests, also required complex analysis to determine the best interests of its shareholders. Because of the complexity inherent in these decisions, the *Unocal* court established a largely structural test that focused on the boards steps in arriving at a particular action rather than the action itself. If a board of directors correctly perceived a threat to its shareholders and responded reasonably in proportion to that threat, the actual decision of the board was subject to the business judgment rule.

The *Unitrin* court provided guidance to boards and practitioners on how to ensure that a response was reasonably proportionate -- so long as a boards defensive responses are not coercive or preclusive and fall within a "range of reasonableness", they will be deemed to be proportional to the threat. The importance of the *Unocal-Unitrin* framework has continued in recent years as the Delaware courts have expanded the contexts in which it is applicable, including

situations where a board responds to receiving an unsolicited bid after entering into a merger agreement n20 or a board takes steps to "lock-up" a transaction. n21 An understanding of *Unocal* and its progeny remains necessary both for a proper comprehension of the fiduciary duties of board members and the ability of legal counsel to structure merger transactions and corporate governance within the parameters of applicable law.

Additional Resources:

Delaware Corporation Law and Practice, Chapter 15, "The Proper Exercise of Directors Responsibilities."

Corporate Governance: Law and Practice, Chapter 12, "Governance in the Corporate Control Context."

Liability of Corporate Officers and Directors, Chapter 14, "Liability in Takeovers, Mergers and Buyouts."

Expert Commentary is the title of this LexisNexis publication. All information provided in this publication is provided for educational purposes only and use of the term "Expert Commentary" is not intended to describe or designate the authors qualifications as a lawyer or in a subspecialty of the law. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.

[Return to Text](#)

n1 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

n2 *See, e.g., Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-711 (Del. 1983).

n3 493 A.2d 946 (Del. 1985).

n4 493 A.2d 946 at 954.

n5 493 A.2d 946 at 954.

n6 *In re Unitrin, Inc.*, 651 A.2d 1361 (Del. 1995).

n7 Mesa already owned 13% of Unocal.

n8 *Unocal*, 493 A.2d at 956.

n9 *Unocal*, 493 A.2d at 956.

n10 *Unitrin*, 651 A.2d at 1361.

n11 *Unitrin*, 651 A.2d at 1370.

n12 *Unitrin*, 651 A.2d at 1378.

n13 *Unitrin*, 651 A.2d at 1376.

n14 *Unitrin*, 651 A.2d at 1386-87.

n15 *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 935 (Del. 2003).

n16 *Williams v. Geier*, 671 A.2d 1368, 1382-83 (Del. 1996) (citations omitted).

n17 *Omnicare*, 818 A.2d at 935.

n18 *Unitrin*, 651 A.2d at 1389.

n19 *Unitrin*, 651 A.2d at 1389.

n20 *Paramount Comm., Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

n21 *Orman v. Cullman*, 2004 Del. Ch. LEXIS 150 (Del. 2004); *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ABOUT THE AUTHOR(S):

Sam Snider is Vice President and Lead Acquisition Counsel for LexisNexis, a division of Reed Elsevier Inc. He is responsible for all aspects of LexisNexis' global mergers, acquisitions, divestitures and restructuring activities, including numerous recent acquisitions in the United States, Europe and Asia. In addition, he leads the Outsourcing and Offshoring team within the LexisNexis legal department.

Prior to joining LexisNexis, Mr. Snider practiced in the M&A department of the Atlanta office of Paul, Hastings, Janofsky & Walker LLP. At Paul Hastings, he represented numerous leading companies including General Electric and Reed Elsevier on a wide range of M&A, technology and commercial matters. He is a frequent writer and speaker on corporate law and M&A matters and was named a Georgia Rising Star by *Atlanta Magazine* and *Georgia Super Lawyers-Rising Star Edition*.

Erik Belenky is a partner in the Corporate Department of Paul, Hastings, Janofsky & Walker LLP in the Atlanta office. He represents clients in all aspects of mergers and acquisitions, corporate finance and private equity transactions. He also regularly advises clients on general corporate and corporate governance matters.

Mr. Belenky's practice is focused primarily in the area of mergers and acquisitions. He has represented leading companies (including The Home Depot, Inc., Reed Elsevier and Superior Essex Inc.) in a wide variety of domestic and cross-border acquisitions and divestitures, restructurings, joint ventures and strategic alliances and other business combination transactions. Mr. Belenky has represented clients in a diverse range of industries, including financial services, consumer products, pulp and paper, building products, basic materials manufacturing, telecommunications, information solutions, publishing and health care. Mr. Belenky was named a Georgia Rising Star by *Atlanta Magazine* and *Georgia Super Lawyers-Rising Star Edition*. **Rachel Miles** is an associate in the Corporate Department of Paul, Hastings, Janofsky & Walker LLP in the Atlanta office. She represents clients in a wide range of corporate transactional matters. Her experience includes mergers, acquisitions, advising clients on matters of corporate governance and assisting clients on general corporate matters

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



16 of 19 DOCUMENTS

Emerging Issues Copyright 2009, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Omnicare, Inc. v. NCS Healthcare, Inc. & Orman v. Cullman

2008 Emerging Issues 3040

R. Samuel Snider, Rachel A. Miles, and Erik L. Belenky on *Omnicare, Inc. v. NCS Healthcare, Inc. and Orman v. Cullman*

By Mr. R. Samuel Snider Esq., Ms. Rachel A. Miles Esq. and Mr. Erik L. Belenky Esq.

October 17, 2008

SUMMARY: Negotiated business combination transactions typically contain so-called deal protection devices. Generally speaking, these measures were recognized by Delaware courts as accepted means of protecting a strategic merger from interference by a third party. The 2003 decision in *Omnicare* and the 2004 decision in *Orman* were watershed cases involving the standard of review and substantive law applicable to certain deal protection devices.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: Negotiated business combination transactions typically contain so-called "deal protection" devices, such as "no-shop" or "window shop" clauses, "force-the-vote" provisions, termination and break-up fees, stock options and stockholder lock-ups. Generally speaking, these measures have been recognized by Delaware courts as accepted means of protecting a strategic merger from interference by a third party, or otherwise compensating a party for such interference. The Delaware Supreme Courts 2003 decision in *Omnicare, Inc. v. NCS Healthcare, Inc.* n1 ("*Omnicare*") and the Delaware Chancery Courts 2004 decision in *Orman v. Cullman* n2 ("*Orman*") were watershed cases involving the standard of review and substantive law applicable to certain deal protection devices specifically stockholder lock-ups.

The *Omnicare* litigation involved NCS Healthcare, Inc., a financially distressed pharmaceutical services provider that was exploring strategic alternatives to bankruptcy in 2000. In the summer of 2001, NCS entered into negotiations with *Omnicare, Inc.* regarding a possible transaction. The deal failed to materialize, however, due to *Omnicare's* insistence that the transaction be structured as an asset sale in bankruptcy. The following year, Genesis Health Ventures, Inc., a competitor of *Omnicare*, proposed to NCS a more favorable merger transaction that would take place outside the bankruptcy context and allow NCS stockholders to recover some value from their investment in NCS. When *Omnicare* became aware that NCS was engaged in negotiations with Genesis, *Omnicare* revised its bid to acquire NCS. Although the terms of its revised bid were more economically favorable to the NCS stockholders than the Genesis proposal, *Omnicare* insisted on numerous closing conditions (such as a due diligence out) that were less favorable and deemed unacceptable by the NCS board of directors.

Having recently lost a bidding war to *Omnicare* in a different transaction, Genesis was unwilling to serve as a "stalking horse" for NCS, and demanded certainty that NCS would complete its merger with Genesis. As such, the

Genesis-NCS merger agreement, which provided for a stock-for-stock exchange valued at \$1.60 per share, contained significant deal protection measures. Most significantly, the merger agreement included a force-the-vote provision, requiring the NCS board to submit the merger to its stockholders for a vote even if the board of directors no longer supported the transaction, and denied the NCS board a "fiduciary out," which would have allowed NCS to terminate the merger agreement in favor of a superior third party bid. Additionally, Genesis required that the two board members who collectively owned the majority of NCS stock, agree to enter into voting agreements which forced the two directors, under any circumstance, to vote their shares in favor of the merger with Genesis. Combined, the voting agreements and the force-the-vote provision essentially locked-up the transaction for Genesis, guaranteeing that the deal would be approved, even if NCS received a superior bid.

After the execution of the merger agreement and voting agreements with Genesis, NCS received a revised proposal from Omnicare, including a purchase price of \$3.50 per share. The NCS board of directors ultimately withdrew its recommendation of the Genesis transaction, but, pursuant to the Genesis merger agreement, the board remained obligated to submit the merger to the NCS stockholders. Omnicare and certain minority NCS stockholders filed suit seeking to enjoin the Genesis merger on the grounds that the NCS board breached its fiduciary duties when it agreed to the terms of the merger.

The Delaware Court of Chancery refused to enjoin the merger. In rendering its decision, the Chancery Court concluded that because the stock-for-stock merger between Genesis and NCS did not involve a change of control, the boards conduct would not be evaluated under the enhanced *Revlon* standard of review. Instead, the Chancery Court applied the business judgment rule, and determined that the board had satisfied its duty of care.

In a 3-2 decision, the Delaware Supreme Court reversed the Chancery Courts decision and enjoined the merger, holding that the NCS directors approval of voting agreements that ensured stockholder approval of the transaction, together with its approval of a merger agreement containing a force-the-vote provision without any ability to terminate the agreement in favor of a superior offer, constituted a breach of their fiduciary duties. Indeed, the Court ruled that a merger agreement requiring the board to submit the merger to the targets stockholders regardless of subsequent bids, combined with a majority stockholder lock-up is per se illegal, despite a fully informed and unconflicted board, the support of stockholders holding a majority voting and economic interest, and the boards belief that the deal protection measures agreed to are, under the circumstances, necessary to obtain the highest stockholder value.

Doctrinally, the Court turned first to the appropriate standard of review and concluded that the enhanced scrutiny standard established in *Unocal*,ⁿ⁴ and not the business judgment rule, applies to the review of deal protection devices, even in transactions not involving a change of control. This is justified, the Court reasoned, by the conflict that arises when a board of directors acts to prevent stockholders from effectively exercising their right to vote contrary to the will of the board, a conflict that may be present when the board adopts measures to protect a merger agreement.ⁿ⁵ In a rarely acknowledged but far reaching conclusion, the Court noted that the same rationale for *Unocal's* "reasonableness" review of actions taken in response to an unsolicited takeover bid applies to defensive measures that are intended to protect a merger agreement that does not result in a change of control. Just as a board has limited discretion to defend against perceived threats to corporate policy, "a board does not have unbridled discretion to defeat perceived threats [to a merger by protecting it] with any draconian means available."ⁿ⁶ Applying the *Unocal* standard, the Court found that the defensive measures adopted by the NCS board were both coercive and preclusive. In the absence of an effective "fiduciary out" clause in the merger agreement, the combination of the force-the-vote provision and the lock-up agreements made it impossible for the Omnicare transaction or any other proposal to succeed, no matter how superior such proposal was to the Genesis proposal. Indeed, the merger was submitted to the NCS stockholders as "a fait accompli."ⁿ⁷ The Court also found the deal protection measures "invalid" on alternative grounds. Specifically, "[t]he NCS board was required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities to the minority stockholders."ⁿ⁸

In the dissenting opinion, the two dissenting justices argued that the value in the certainty provided by lock-up agreements should not be underestimated, and that any bright-line rules prohibiting such arrangements could discourage

otherwise permissible conduct. The dissent criticized the majority for creating a "new rule" without taking the circumstances of the negotiation process into consideration. n9 According to the dissent, the NCS board did not breach its fiduciary duties since agreeing to the deal protection devices and the exclusion of a fiduciary out clause was necessary in order to continue negotiations with Genesis. The dissenting justices cautioned that the majority's holding should be interpreted narrowly.

One year later, the Delaware courts had an opportunity to clarify the types of deal protections that would be upheld following *Omnicare*. The Delaware Court of Chancery's 2004 decision in *Orman* involved a merger between General Cigar Holdings, Inc. and Swedish Match AB. Members of the Cullman family were controlling stockholders and members of the board of directors of General Cigar, the target company. In late 1999, Swedish Match AB contacted the Cullmans about acquiring a significant stake in General Cigars business. Under the terms of the proposed transaction, Swedish Match would acquire half of the Cullmans controlling interest and all of the public stockholders interest in General Cigar. Swedish Match also wanted two members of the Cullman family to maintain management responsibility of the company's day-to-day operations after the merger. The board of directors formed a special committee to advise and make recommendations to the board concerning the transaction. The special committee retained Deutsche Bank Securities, Inc. to render a fairness opinion on the proposed transaction. Based on Deutsche Bank's opinion that the proposed offer price of \$15.25 per share was fair to the public stockholders, the special committee unanimously recommended that the full board approve the merger.

In connection with the merger agreement, Swedish Match required the Cullmans to enter into a voting agreement which forced them to vote their shares for the merger and against any alternative acquisition proposals for 18 months following the termination of the merger agreement. The merger agreement permitted General Cigars board of directors to consider unsolicited third party offers if the board, upon recommendation from the special committee, determined that the offer was bona fide and more favorable to General Cigars stockholders. Furthermore, the board could withdraw its recommendation of the merger if it concluded that its fiduciary duties required it to do so. Finally, the merger agreement provided that the merger could not proceed without the approval of General Cigars minority stockholders.

A plaintiff minority stockholder brought suit against the members of the Cullman family that served on the board of directors of General Cigar, arguing that the Cullmans had breached their fiduciary duties by entering into the voting agreements, and that the deal protection measures were invalid under *Unocal*. The Chancery Court first addressed the voting agreements and began by noting that contracts purporting to limit directors fiduciary duties are impermissible. In this case, however, the Cullmans entered into the voting agreements in their capacity as stockholders--and not as directors--and nothing in the voting agreement limited their ability to exercise their duties as directors.

The Chancery Court then turned to the deal protection measures. Applying the *Unocal* standard, the Chancery Court determined that the first prong--requiring the board of directors to demonstrate that a danger to corporate policy and effectiveness exists without the deal protection device--was satisfied since General Cigar risked losing the transaction without the voting arrangement. The Chancery Court also found that the lock-up was neither preclusive nor coercive, thereby meeting the second prong of the *Unocal* test. There was nothing in the record to suggest that the lock-up had the effect of causing General Cigars stockholders to vote for the transaction for some reason other than its merits. The Chancery Court noted that, unlike in *Omnicare*, the voting arrangement did not amount to "a fait accompli": even though their decision may have been influenced by the existence of the lock-up, General Cigars public stockholders were free to reject the merger. Furthermore, General Cigars board had negotiated a meaningful fiduciary out: if the board of directors decided to recommend that the stockholders reject the transaction, the public stockholders retained the power to reject the merger through the "majority of the minority" stockholder voting provision. The Court then finally determined that the lock-up arrangement fell within the range of reasonableness since General Cigar risked losing the Swedish Match offer in the absence of any deal protection mechanisms, and being left with no comparable alternative transaction.

The voting arrangement at issue in *Orman* survived the courts review under the *Unocal* standard primarily on the basis of the factual differences from those presented in *Omnicare*: the controlling stockholders in *Orman* agreed to

support the merger in their capacity as stockholders, but did not limit their ability to recommend that the public stockholders reject the transaction; the *Orman* board retained an effective fiduciary out, while the *Omnicare* board did not; and, unlike in *Omnicare*, the approval of the merger by the *Orman* stockholders was not "a fait accompli" or "mathematically certain". n10

While the full implications of *Omnicare* and *Orman* continue to be the subject of debate, these seminal cases provide practitioners useful guidance in several areas. First, it appears that deal protection measures will be evaluated under the heightened *Unocal* standard of review and not the business judgment rule, even in transactions not involving a change of control. Second, Delaware courts will seek to balance a boards desire to protect and preserve a particular transaction against the stockholders statutory right to vote in a contrary manner. In the case of lock-ups, *Omnicare* and *Orman* signal that they will be invalid if they impinge on the ability of stockholders to accept a topping bid; and they will be upheld if stockholders retain the right to "just say no" to the proposed transaction.

Additional Resources:

Delaware Corporation Law and Practice, Chapter 15, "The Proper Exercise of Directors Responsibilities."

Corporate Governance: Law and Practice, Chapter 12, "Governance in the Corporate Control Context."

Liability of Corporate Officers and Directors, Chapter 14, "Liability in Takeovers, Mergers and Buyouts."

Return to Text

n1 818 A.2d 914 (Del. 2003).

n2 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004).

n3 See *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173 (Del. 1986).

n4 See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). The *Unocal* standard, as subsequently informed by *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995), generally requires courts to engage in a three-step process: first, the court should determine if there was a reasonably perceived threat to corporate policy; second, the court should determine if the defensive steps adopted or taken were "coercive or preclusive"; and finally, if the defensive measures were not coercive or preclusive, the court should evaluate whether the measures were within a "range of reasonableness".

n5 *Omnicare*, 818 A.2d at 930.

n6 *Omnicare*, 818 A.2d at 932.

n7 *Omnicare*, 818 A.2d at 936. Although not the primary importance of the *Omnicare* decision, practitioners should note that the *Omnicare* courts focus on the mathematical certainty of approving the Genesis transaction effectively established on test of what constitutes draconian under *Unocal* an action by a board that does not allow any possibility that the board may react to subsequent events, even if a more favorable opportunity arises following that action.

n8 *Omnicare*, 818 A.2d at 939.

n9 *Omnicare*, 818 A.2d at 940.

n10 *Orman*, 2004 Del. Ch. LEXIS at 25, 35. Expert Commentary is the title of this LexisNexis publication. All information provided in this publication is provided for educational purposes only and use of the term Expert Commentary is not intended to describe or designate the authors qualifications as a lawyer or in a subspecialty of the law. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

ABOUT THE AUTHOR(S):

Sam Snider is Vice President and Lead Acquisition Counsel for LexisNexis, a division of Reed Elsevier Inc. He is responsible for all aspects of LexisNexis' global mergers, acquisitions, divestitures and restructuring activities, including numerous recent acquisitions in the United States, Europe and Asia. In addition, he leads the Outsourcing and Offshoring team within the LexisNexis legal department.

Prior to joining LexisNexis, Mr. Snider practiced in the M&A department of the Atlanta office of Paul, Hastings, Janofsky & Walker LLP. At Paul Hastings, he represented numerous leading companies including General Electric and Reed Elsevier on a wide range of M&A, technology and commercial matters. He is a frequent writer and speaker on corporate law and M&A matters and was named a Georgia Rising Star by *Atlanta Magazine* and *Georgia Super Lawyers-Rising Star Edition*.

Erik Belenky is a partner in the Corporate Department of Paul, Hastings, Janofsky & Walker LLP in the Atlanta office. He represents clients in all aspects of mergers and acquisitions, corporate finance and private equity transactions. He also regularly advises clients on general corporate and corporate governance matters.

Mr. Belenky's practice is focused primarily in the area of mergers and acquisitions. He has represented leading companies (including The Home Depot, Inc., Reed Elsevier and Superior Essex Inc.) in a wide variety of domestic and cross-border acquisitions and divestitures, restructurings, joint ventures and strategic alliances and other business combination transactions. Mr. Belenky has represented clients in a diverse range of industries, including financial services, consumer products, pulp and paper, building products, basic materials manufacturing, telecommunications, information solutions, publishing and health care. Mr. Belenky was named a Georgia Rising Star by *Atlanta Magazine* and *Georgia Super Lawyers-Rising Star Edition*. **Rachel Miles** is an associate in the Corporate Department of Paul, Hastings, Janofsky & Walker LLP in the Atlanta office. She represents clients in a wide range of corporate transactional matters. Her experience includes mergers, acquisitions, advising clients on matters of corporate governance and assisting clients on general corporate matters.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



17 of 19 DOCUMENTS

Emerging Issues Copyright 2008, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Aquila and Sawyer on Cross-Border Deals

2008 Emerging Issues 2636

FRANK AQUILA & MELISSA SAWYER ON CROSS-BORDER DEALS

By Frank Aquila and Melissa Sawyer

July 30, 2008

SUMMARY: Frank Aquila and Melissa Sawyer highlight key characteristics of cross-border M&A deals that counsel should discuss with their client at the outset of the transaction.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Aquila, Frank, Sawyer, Melissa. Cross-Border Deals. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

Frank Aquila and Melissa Sawyer highlight key characteristics of cross-border M&A deals that counsel should discuss with their client at the outset of the transaction, including:

- . Disclosure and announcement issues;
- . Regulatory and third party notification and approval issues;
- . Securities law issues;
- . Choice of law and dispute resolution issues;
- . Selecting and working with local counsel;
- . Governance issues; and
- . Recent developments in cross-border transactions.

Cross-border deals are on the rise. The phrase cross-border deals refers to a broad range of transactions in which the parties are from different jurisdictions. The league tables show that U.S. law firms are involved in billions of dollars of cross-border transactions every quarter. n1 Recently, developments in the credit markets and the devaluation of the U.S. dollar, among other things, have resulted in increased activity by non-U.S. investors into U.S. businesses. Non-U.S. acquirers accounted for almost 25% of the approximately \$1.4 trillion of U.S. M&A activity in 2007. The twelve biggest sovereign wealth funds currently have approximately \$2.9 trillion of assets under management and have

invested almost \$60 billion in U.S. financing institutions alone in the past year. n2 Non-U.S. buyers have also shown an intense appetite for U.S. infrastructure assets (like toll roads and ports) that have historically had steady returns. Meanwhile, many U.S. companies are increasingly looking for potential synergistic M&A opportunities in non-U.S. markets that they hope to enter or where they hope to expand existing businesses.

Cross-border deals raise a host of legal and technical challenges beyond those that typically arise in purely domestic transactions. One practical side-effect of the rise of cross-border transactions is that practitioners now have access to information about a plethora of M&A technologies (including ideas about transaction structures, financing methodologies and regulatory compliance) that are used in various jurisdictions. The extent of the available options can be overwhelming at times, but the core principles remain the same across most transactions. This article highlights certain of the key challenges and provides some practical tips for addressing issues that regularly arise in cross-border transactions.

Disclosure/Announcement Issues

NonU.S. acquirers seeking to acquire U.S. businesses are often surprised by the extent of the public disclosure that they or the seller/target are required to make regarding the transaction. When representing a nonU.S. buyer, it is critical to educate your client about these requirements early in the process. Among other things, the U.S. disclosures may trigger disclosure requirements in the clients home jurisdiction, impact key transaction terms or acquisition strategy and/or affect the regulatory approval process.

There are eight principle sources of such disclosure obligations:

1. Beneficial Ownership Reporting on Schedule 13D. In most cases, an individual or entity that acquires beneficial ownership of more than 5% of a class of securities that is registered under Section 12 of the Securities Exchange Act of 1934 (the Exchange Act) is required to file a Schedule 13G or a Schedule 13D with the Securities and Exchange Commission (the SEC). NonU.S. clients should also be made aware that these reporting obligations can also arise solely as a result of their forming a group with other holders and/or holding derivative instruments carrying some, but not all, indicia of ownership. Those clients who already have a Schedule 13D on file with respect to an issuer also need to be made aware of the possibility of having to disclose a change of intent with respect to their ownership of the issuers securities. n3

2. Transaction Reporting Under Section 16. Shareholders that hold 10% or more of a public company may be subject to Section 16 of the Exchange Act, including the obligation to make filings with the SEC to report acquisitions and dispositions of securities and the profit disgorgement rules. n4

3. Other SEC Filings. Once a transaction is announced, the parties may be required to make filings pursuant to the tender offer rules (e.g., Schedule TO), the going private transaction rules (e.g., Schedule 13E-3), the proxy rules (e.g., Schedule 14A), Regulation M-A (e.g., 14a-12 and 425 filings), general Exchange Act reporting requirements (e.g., Forms 8-K, 10-K and/or 10-K) and/or Regulation FD, among others. n5

4. Stock Exchange Requirements. Parties may be required to make disclosures about a transaction pursuant to stock exchange rules. n6

5. Hart-Scott-Rodino Requirements. If the proposed transaction requires an HSR filing and the parties request early termination, any grant of early termination will be disclosed on the Federal Trade Commissions website. n7

6. Regulated Industry Requirements. Transactions relating to certain regulated industries (e.g., banking, insurance, energy) may be subject to additional disclosure requirements and/or the risk of leaks may be enhanced by the need to brief regulators about the transaction.

7. Premature Disclosures. While not unique to cross-border transactions, premature disclosures/leaks about a

transaction can generate intense speculation in the media and trigger disclosure obligations under stock exchange rules and securities regulations.

8. Litigation. NonU.S. clients who are unfamiliar with the U.S. legal system should be advised early and often about the risk of litigation in an acquisition of a U.S. public company, especially where the transaction will be subject to a heightened standard of review under state law. Among other matters, outside counsel should brief a non-U.S. client about the broad scope of a typical litigation document production and basic guidelines regarding preserving the attorney-client privilege. For example, it is important that nonU.S. clients know that sharing legal advice with investment bankers outside of the U.S. can cause a loss of privilege with respect to the advice and the subject matter of the advice for purposes of U.S. litigation.

U.S. buyers of nonU.S. businesses should consult with local counsel in the relevant jurisdiction(s) to confirm what disclosure requirements, if any, apply under local law. The selection and use of local counsel is addressed in more detail in Section IV of this article. The relevant jurisdictions may include the targets domicile as well as other jurisdictions in which the target or its affiliates conduct business or own assets.

Regulatory and Third Party Notification and Approval Issues

The regulatory and third party notifications and approvals required for a given transaction vary by jurisdiction, industry, transaction structure and transaction size, among other factors. The nature and extent of the required approvals can impact the timing and certainty of closing.

NonU.S. investors into the U.S. should consider the following regulatory filing/approval requirements, among others:

1. Exon-Florio Act. The U.S. Congress enacted the Exon-Florio Amendment, Section 721 of the Defense Production Act of 1950, as part of the Omnibus Trade and Competitiveness Act of 1988. The statute grants the U.S. President the authority to block or suspend a merger, acquisition or takeover by a non-U.S. entity if there is credible evidence that a foreign interest exercising control might take action that threatens to impair the national security and existing provisions of law do not provide adequate and appropriate authority for the President to protect the national security in the matter before the President. After the Dubai World debacle of 2006, most foreign investors into the U.S. are aware of the U.S. Exon-Florio Act and related requirements to notify the Committee on Foreign Investment in the United States (CFIUS) of certain transactions that could impact national security. Those representing sovereign wealth funds and other investors affiliated with non-U.S. governments should be particularly attentive to these rules and consider whether an Exon-Florio filing is desirable. In 2007, the U.S. enacted the Foreign Investment and National Security Act of 2007 (FINSAs), which, among other things, requires heightened scrutiny of certain acquisitions, including those by foreign government-controlled entities and transactions involving U.S. critical infrastructure. n8 FINSAs came on the heels of a significant upswing of CFIUS scrutiny of cross-border transactions and opponents expressed concern that the legislation would close the door incrementally to potential investors. n9 NonU.S. investors may want to consider hiring lobbyists and/or public relation specialists to help them navigate the potential political minefield associated with Exon-Florio and related legislative requirements.

2. Regulated Industries. Changes of control in certain regulated industries can trigger extensive filing and approval requirements. This is the case in the banking, insurance and energy industries in the U.S., among others. It is important to make sure that nonU.S. clients understand not just those requirements that are triggered by the transaction itself, but also any ongoing operational, capitalization, governance and other requirements under the applicable regulations.

3. Hart-Scott-Rodino Act. The U.S. pre-merger notification regime applies to acquisitions of U.S. businesses and entities by non-U.S. acquirers. NonU.S. clients, however, may require more time to prepare a first-time HSR filing because, among other reasons, they may not track their revenues using the North American Industry Classification

codes required by the HSR form. In transactions where there appear to be antitrust issues, it is also important to prepare non-U.S. clients for the possibility of getting a second request from the Department of Justice. NonU.S. clients unfamiliar with the second request process may not be fully aware of the amount of time and resources required to comply with a second request.

4. Stock Exchange Requirements. While generally not a gating item in most cross-border transactions, the buyer of a company listed on a U.S. securities exchange will undoubtedly require advice about the exchanges listing rules and associated notification and delisting requirements.

Certain of these notification/approval processes require the parties to a cross-border transaction to provide extensive or sensitive personal information concerning officers and directors. Outside counsel should be prepared to discuss the extent to which the submissions will remain confidential, including whether the filings are subject to Freedom of Information Act requests.

U.S. clients investing outside the U.S. will generally face similar regulation of nonU.S. investments and industry specific regulation, antitrust/competition issues and stock exchange requirements. They should consult with local counsel to confirm whether there are any other jurisdiction-specific requirements. Two of the most common requirements in other jurisdictions that are not typical in U.S. domestic transactions are (1) monetary authority filings/approvals and (2) works council approvals.

Securities Law Issues

NonU.S. clients investing in the U.S. who want to use stock consideration in the transaction will likely require extensive advice concerning their obligations under the U.S. securities laws. Among the matters they will need to consider are the following:

1. Using Stock Consideration. NonU.S. buyers who intend to issue securities to a targets shareholders or to access the U.S. capital markets to finance the transaction need to consider the U.S. securities registration and disclosure requirements, as well as the associated liability rules. For example, any failure of the issuers historical audited financial statements (which may not have been prepared in accordance with GAAP) to satisfy SEC requirements can be a source of extensive delay and expense in the registration process. These issues are too numerous and complex to cover in any reasonable level of detail here but suffice it to say that it is important to determine the form of consideration early in the process because it will have a critical impact on timing.

2. Flow-Back. The use of stock consideration by a non-U.S. issuer can also have a unique impact on non-U.S. issuers in the form of so-called flow-back issues. Many U.S. institutional holders, including mutual funds, are required to hold a certain percentage of domestic shares or to track a domestic index. For that reason, they may be unwilling to accept non-U.S. stock consideration or, if they accept it, may sell down their position shortly after the closing resulting in a decline in market price. Flow-back is especially an issue in transactions where there is low insider ownership of the target.

3. Tender Offer and Proxy Rules. Generally, foreign private issuers n10 are not subject to the proxy rules, but many cross-border transactions are structured as tender offers or exchange offers and may be subject to the Williams Act. In some cases, the Williams Act conflicts with regulatory requirements to which the acquirer is subject in other jurisdictions. The SEC has issued no-action relief in certain cases of such conflicts in the past and encourages buyers to reach out to the SEC early in the acquisition process to discuss potential issues or problems. In some cases the SEC is able to work directly with the non-U.S. regulatory authority to reconcile the regulatory concerns of both jurisdictions. Certain transactions may be eligible for the so-called Tier I or Tier II exemptions under the U.S. tender offer rules. These are exemptions from the registration requirements of Section 5 of the Securities Act of 1933, from the application of Rule 13e-3 and from certain provisions of the tender offer rules. The availability of the exemptions depends on the percentage of the targets shares held by U.S. persons. In addition, Canadian parties may be able to take advantage of the

multi-jurisdictional disclosure system.

4. Other Rules Governing Purchases of Securities. NonU.S. clients who plan to purchase securities of a U.S. issuer also need to be cognizant of the U.S. insider trading rules and market manipulation rules.

U.S. persons investing in other jurisdictions may face similar issues under local law and should consult with local counsel about securities law matters.

Choice of Law and Dispute Resolution Issues; Selecting and Working with Local Counsel

Regardless of the structure of the transaction, parties in cross-border transactions always need to agree upon the governing law of their definitive agreements and how any later disputes will be resolved. Choice of law is a complex question and is not always at the discretion of the parties. This is another issue on which the parties should consult local counsel. Among other things, the parties need to consider the following factors in their choice of law analysis:

1. Applicable Law. On the one hand, certain jurisdictions may not permit the parties to avail themselves of the jurisdictions judicial system for purposes of enforcing a private contract unless the transaction meets certain threshold quantitative or qualitative criteria. On the other hand, certain jurisdictions may not be willing to enforce an extra-territorial judgment regarding a private contract. For example, certain jurisdictions mandate that a shareholders agreement in respect of an entity formed in the jurisdiction must be governed by the law of the jurisdiction. If not, the jurisdiction would not enforce specific performance of transfer restrictions over the shares, among other matters, rendering the restrictions largely ineffective.

2. Comparative Law. The relative merits of different legal regimes obviously vary by transaction. In general, however, it is preferable that the governing law be one that is relatively predictable in its application to large multinational transactions. For example, parties frequently select New York law as the governing law in cross-border deals because New York has a relatively well-developed body of contract law.

3. Bias and Political Risk. A nonU.S. investor may prefer not to be subject to dispute resolution in the home jurisdiction of its counterparty, whether arbitration or otherwise. This is especially the case where the industry in question inspires strong national sentiment or is the subject of actual or prospective protectionist legislation. Project finance practitioners have developed numerous techniques to enhance the enforceability of agreements in transactions where there is a risk that a business or industry could be nationalized or enforcement will be challenging. Those techniques can be equally useful in structuring M&A transactions.

4. Desirability of Expert Resolution and/or Arbitration. The arguments for and against arbitration and alternative dispute resolution processes are not unique to cross-border transactions. If the parties select arbitration in a cross-border transaction, they should take care to agree up front what arbitration rules will govern, where the arbitration will take place and what language will be used. They should also confirm that the arbitration ruling will be binding and enforceable in all relevant jurisdictions.

5. Availability of Remedies. In selecting a governing law or dispute resolution process, the parties should consider whether all the desired remedies will be available to them. For example, certain jurisdictions may not provide for punitive damages and/or specific enforcement, while other jurisdictions may go so far as to impose criminal remedies in connection with certain contract disputes.

6. Documentation. The manner in which a transaction is documented will be driven to a great extent by the customs and legal requirements of the jurisdiction of the governing law the parties select. Civil law jurisdictions have different documentation and recordation customs and requirements for asset transfers than common law jurisdictions.

Given all of the foregoing considerations in selecting a governing law and dispute resolution process, it is quite

common for clients in cross-border transactions to engage local counsel in multiple jurisdictions. The lead outside counsel will face a difficult challenge in coordinating the advice from multiple local lawyers, especially where there are language barriers and significant differences in the applicable legal regimes and the level of experience with large multinational transactions. Wherever possible, it is useful to develop ongoing relationships with local counsel in various countries so that you can recommend tried and tested local counsel to your clients. Standardized instructions are often ineffective and it is frequently more efficient for a senior member of the team to take time to talk to the local advisors and challenge any advice that seems inconsistent with prior experience or intuition. This will help to minimize the risk of miscommunication and misinformation based on an incomplete picture of the transaction.

In working with local counsel, it is important to be sensitive to cultural differences. Informal email communication is not widely used in all jurisdictions. In addition, in some jurisdictions, local counsel will not be accustomed to working over holidays or on weekends (and, indeed, may not have the facilities to do so). It is also important to be sensitive to confidentiality considerations. In some smaller jurisdictions, it can be the case that many of the most experienced lawyers, bankers and business leaders regularly interact socially or in business and politics and feel great loyalty to each other, even when on opposite sides of a transaction.

Even though it is often necessary to obtain local counsel advice in connection with cross-border transactions, it is important to maintain a sense of materiality. The target may have assets in a country where there is a time-consuming local regulatory approval requirement, but if the assets are not material to the transaction it may be preferable to divest them or hold them separate so as not to delay the larger deal.

Governance Issues

In connection with establishing a joint venture or other entity in a crossborder transaction, it may be necessary to reconcile two or more competing ideologies regarding corporate governance and to educate the parties about their obligations under applicable law.

Among other issues, the parties should consider the applicable fiduciary duties, board independence and related requirements and requirements related to holding board and shareholder meetings. These governance issues may intersect with other aspects of the transaction structure. For example, if the rationale for choosing to form an entity in a particular jurisdiction is to obtain the benefit of a lower tax rate, the parties should confirm whether they need to demonstrate to any tax authority that they actually conduct operations in or have employees permanently located in that jurisdiction.

Parties to a cross-border transaction should also be cognizant of cultural differences regarding corporate governance. The U.S. style of board decision-making is not ubiquitous. In some countries, boards meet much more frequently and are much more deeply engaged in the day-to-day operations of businesses. In other countries, the board has a mostly advisory rule and little practical authority to override decisions dictated by management or controlling shareholders.

Other Issues. There are innumerable other legal issues that arise uniquely in cross-border transactions. In many cases, involving subject matter specialists is the first step to spotting these issues. For example, a tax specialist will be able to provide advice regarding the availability of tax treaties given the transaction structure, and may be able to spot cash trap and related non-U.S. tax issues that could impact the financing structure for the transaction. Another example relates to employee compensation and benefits. Designing a post-closing equity compensation scheme in a cross-border transaction raises complex questions of securities law, labor law and valuation, among other issues. U.S. employee compensation practices vary greatly from non-U.S. practices, especially as they relate to equity granting policies and changes in control, and involving lawyers and consultants with expertise in this area from the outset is usually advisable.

Recent Developments

It is not yet entirely clear what impact recent developments in the financial markets may have on cross-border transactions. On the one hand, given the weak dollar, U.S. assets may seem cheap to sovereign wealth funds flush with dollars. Non-U.S. buyers have shown an intense appetite for U.S. infrastructure assets (like toll roads and ports) that have historically had steady returns. On the other hand, both in the U.S. and abroad, the current economic climate may generate some political fall-out from the previous successes (or excesses, as the case may be) of private equity. Given the recent instability in the credit markets, regulatory scrutiny of highly leveraged transactions and club deals may increase. All of these developments suggest that outside counsels advice on crossborder transactions should address not only the technical issues described above, but should also address legislative and political developments that can impact the structuring and valuation of transactions in the future.

For more on U.S. mergers and acquisitions, *see* Corporate Acquisitions and Mergers (Matthew Bender).

For more on U.S. securities laws, *see* Securities Laws Techniques, Federal Securities Act of 1933 and Federal Securities Exchange Act of 1934 (Matthew Bender).

[Return to Text](#)

n1 . Statistics available on [TheDeal.com](#).

n2

[2]. *Invasion of the Sovereign Wealth Funds*, *The Economist*, January 19, 2008.

n3

[3]. For additional information on Schedule 13D and Schedule 13G, see Thomas R. Stephens, Bureau of National Affairs, *Beneficial Ownership Reporting: Schedules 13D and 13G* (2d ed. 1996).

n4

[4]. For additional information on Section 16, see Peter J. Romeo & Alan L. Dye, *Section 16 Treatise & Reporting Guide* (2d ed. 2004).

n5

[5]. For additional information on these SEC filings, see *Securities Law Techniques, Reporting and Disclosure Requirements Under the Securities Exchange Act of 1934, Corporate Acquisitions and Mergers*, Ch. 25 (Matthew Bender).

n6

[6]. See, e.g., New York Stock Exchange Listed Company Manual, Rule 202.05 (Timely Disclosure of Material New Developments). If any party is a broker-dealer, the Financial Institution Regulatory Authority (FINRA) rules may also apply.

n7

[7]. For additional information concerning the HSR Act filing requirements, see American Bar Association, *The Premerger Notification Practice Manual* (4th Ed. 2007).

n8

[8]. On April 21, 2008, CFIUS published proposed regulations under FINSIA. As of the date of this article, the authors analysis of the proposed regulations is ongoing. The proposed regulations will be subject to a 30-day comment period.

n9

[9]. CFIUS considered 113 transactions in 2006, an increase of 74% from 2005, and conducted seven second-stage investigations in 2006, equaling the number of second-stage investigations of the previous five years combined. The Associated Press, *A year after Dubai Port deal, Congress sends investment bill to White House*, International Herald Tribune (Americas), July 11, 2007. Recent transactions subjected to CFIUS review including the Rio Tinto/Alcan transaction, the NTT Communications/Verio transaction, the Software AG acquisition of SAGA Systems, the Check Point/Sourcefire transaction, China National Offshore Oil Corporations bid for Unocal, and Lenovos acquisition of IBMs personal computer and laptop unit.

n10

[10]. Under Rule 3b-4 under the Exchange Act, the term foreign private issuer means any foreign issuer other than a foreign government except an issuer meeting the following conditions: (1) more than 50% of the issuers outstanding voting securities are directly or indirectly held of record by residents of the United States; and (2) any of the following: (i) the majority of the executive officers or directors are United States citizens or residents; (ii) more than 50% of the assets of the issuer are located in the United States; and (iii) the business of the issuer is administered principally in the United States. The term foreign issuer means any issuer which is a

foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country. The term foreign government means the government of any foreign country or of any political subdivision of a foreign country.

n11

[11]. For example, until 1997, when Guinness merged with Grand Metropolitan to form a company now called Diageo plc, mergers of English companies were not documented pursuant to lengthy U.S.-style merger agreements.

ABOUT THE AUTHOR(S):

Frank Aquila has been a partner in the Sullivan & Cromwell LLP Mergers & Acquisitions Group since 1992. His practice focuses on mergers, acquisitions, strategic alliances and corporate governance matters for large U.S. and non[shy]U.S. multinational corporations. Mr. Aquila received a Burton Award for Legal Achievement in 2005. He received his A.B. degree from Columbia University and his J.D. degree from Brooklyn Law School.

Melissa Sawyer has been an associate in the Sullivan & Cromwell LLP Mergers & Acquisitions Group since 2000. Her practice focuses on all aspects of mergers and acquisitions. Ms. Sawyer was featured in *The Facebook of Wall Streets Future* (New York Times, October 3, 2007) as one of Wall Streets next generation of deal makers. She received her B.A. degree from Washington & Lee University and her J.D. degree from the University of Virginia Law School.

Expert Commentary is the title of this LexisNexis publication. All information provided in this publication is provided for educational purposes only and use of the term Expert Commentary is not intended to describe or designate the authors qualifications as a lawyer or in a subspecialty of the law. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.



18 of 19 DOCUMENTS

Emerging Issues Copyright 2008, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Reuter on CSX decision and Unfair Advantages for Security holders

2008 Emerging Issues 2582

Loopholes Provide Activist Security holders Unfair Advantages in Takeover Contests; How Targets Can Fight Back

By F. Mark Reuter

July 19, 2008

SUMMARY: This commentary, written by F. Mark Reuter of Keating Muething & Klekamp PLL, analyzes the CSX case in depth, and posits that it demonstrates the modern trend of hedge funds employing sophisticated legal practices to bring controversial proposals and to replace boards of directors.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Recently, activist hedge funds obtained a favorable court decision, allowing greater stockholder leeway when making proposals and director nominations. In *CSX v. Childrens Fund Mgmt. (UK) LLP*, n1 a court struck down a target companys attempt to prevent activist hedge funds from voting their shares at the annual stockholders meeting. The court reluctantly refused to enjoin activist funds from voting their hedged shares at the annual stockholders meeting, despite the funds alleged violation of Securities and Exchange Commission (SEC) regulations. This case demonstrates the modern trend of hedge funds employing sophisticated legal practices to bring controversial proposals and to replace boards of directors.

CSX Corp. v. Childrens Investment Fund Mgmt. In *CSX*, the Federal District Court for the Southern District of New York ruled that two hedge funds violated SEC regulations in connection with advance notice and disclosure requirements for stockholder nominations and proposals. The hedge funds, The Childrens Investment Fund (TCI) and 3G, targeted the railroad company CSX Corp., a Virginia corporation, for replacement of its Board. n2 Initially, the hedge funds acquired derivative interest agreements, known as total return swaps, with several banks, and then approached CSX Board members with their demands. Both hedge funds purposefully distributed their derivative interests, never exceeding 5% of CSX ownership at any one institution, n3 to avoid SEC reporting requirements. n4 When the CSX Board of Directors dismissed their demands, the hedge funds consolidated their derivates and purchased stock. After making the required SEC disclosures, the funds prepared to make a shareholder proposal and to wage a proxy fight to replace two members of the CSX Board. n5

CSX filed suit to enjoin the funds from voting any shares acquired during the period between when the funds should have made the SEC disclosures and when the funds actually made such disclosures. n6 CSX argued that the hedge funds derivative interest in CSX stock constituted beneficial ownership under the SEC regulations, and therefore, the funds should have reported their ownership interests. n7

The court ruled in favor of CSX, even though it found that derivative instruments do not constitute beneficial ownership per se. n8 The court reasoned that the funds were beneficial owners because they purposefully designed their investment strategy with the intent to avoid SEC reporting requirements. n9 Thus, the funds were required to disclose their derivative interests to the SEC and CSXs stockholders. Nevertheless, the court found that the funds failure to disclose derivative interests in their proxy statements *did not* violate CSXs By-Laws, whose definition of beneficial ownership was not broad enough to compel disclosure of total return swaps. n10

Activist Practices: Coordinated Efforts and Derivative Securities. This case highlights the increased use of two practices by activist securityholders. First, it is now common for multiple hedge funds to invest in the same target; activist funds believe that their collective activities will yield desired results. Although federal securities laws do not prohibit securityholders from communicating with one another regarding their investments in a target, securityholders are required to report to the SEC if and when they beneficially own in the aggregate more than 5% of the targets securities when they have entered into a relationship, understanding, arrangement or contract regarding their investments. n11

The goal of these rules is to alert the marketplace to any incipient control contest. At least until it filed its *amicus curiae* brief to the CSX court earlier this month, n12 the SEC had generally defined beneficial ownership broadly. Unfortunately, as a result of evidentiary issues, the SEC and courts rarely find that coordinated action of activist shareholders violates this group reporting requirement under Section 13(d) of the Securities Exchange Act of 1934.

Second, activist securityholders are more frequently purchasing derivative instruments, such as hedges and swaps connected to the targets voting stock. The SEC suggested in its *amicus* brief that total return equity swaps are not subject to beneficial ownership reporting requirements. n13 Combined with the feature that such swaps allow activist securityholders to leverage and increase potential returns in targets, these instruments now allow activist alliances to exist virtually undetected.

Targets Fight Back. Public companies can fight back in response to this jurisprudence and the coordinated actions of activist shareholders that accumulate positions in swaps and hedges.

Several companies have recently amended their by-laws in order to deal with these issues. n14 The amendments close the advance notice loophole by requiring securityholders to fully disclose their positions and relationships when making nominations and proposals. Requiring full disclosure limits a hedge funds ability to operate beyond the by-laws and SEC regulations, making a company a much less inviting target.

For example, this spring, both Coach, Inc. and Sara Lee Corp. amended their advance notice provisions, broadening the required disclosures. n15 The changes made to each companys by-laws are nearly identical.

First, both companies added provisions that require securityholders, when making a nomination or proposal, to disclose any hedges or transactions designed either (1) to manage or mitigate the securityholders risk or benefit, or (2) to increase or decrease the securityholders voting power. n16 Such language prevents activist hedge funds from over- or under-representing their interests in the corporation when making nominations or proposals.

Second, both companies added broad definitions of Stockholder Associated Person (SAP), and required SAPs to also disclose their positions. n17 Such amended by-laws define an SAP as any person or entity that collaborates with any shareholder, or any beneficial owner of stock whose owner of record is the shareholder, or any other person controlling, controlled by or under common control with an SAP. n18 This provision compels disclosure of combinations so that targets can become more aware of combinations and arrangements behind a nomination or proposal. Without being required to disclose such interests pursuant to this expanded concept, a hedge fund can gain a powerful advantage in a proxy contest by designing its investments to avoid full disclosure.

Additionally, Coach moved its annual meeting advance notice window further out from the anniversary of the mailing of the previous years proxy statement: from a 90 to 120 day window before the anniversary to a 120-150 day window before the anniversary. n19 Requiring notice another month before the annual meeting discourages short-term investors from targeting the company, and increases a companys opportunity to stave off a hedge fund takeover.

Conclusion. Based on *CSX*, companies should consider amending their by-laws to insert a broad definition of beneficial ownership to include all swaps, hedges, and other derivative instruments, in order to compel the fullest possible disclosure of securityholder interests. Such a broad definition compels complete disclosure, affording all stockholders and the board of directors a true picture of the proponents position.

In addition to by-law amendments, companies should also reconsider how they deal with activist stockholders. Many public corporations have traditionally been adverse to stockholder proposals and nominations, setting the stage for litigation and proxy fights. A softer approach through stockholder inclusion in corporate governance and board of directors cognizance of stockholder concerns may yield better results and help avoid costly litigation.

Return to Text

n1 * Bryan A. Jacobs, an associate at Keating Muething & Klekamp PLL, contributed to this article.

[1]. *CSX Corp. v. Childrens Investment Fund Mgmt. (UK) LLP*, 08 Civ. 2764, 13 (S.D.N.Y. 6-11-2008).

n2

[2]. *CSX Corp. v. Childrens Investment Fund Mgmt. (UK) LLP*, 08 Civ. 2764, 13 (S.D.N.Y. 6-11-2008).

n3

[3]. The Williams Act, 15 U.S.C. § 79m.

n4

[4]. *Id.* at 65.

n5

[5]. *CSX Corp.* at 40.

n6

[6]. *Id.* at 5.

n7

[7]. *Id.* at 45.

n8

[8]. *CSX Corp.* at 64.

n9

[9]. *Id.* at 72.

n10

[10]. *Id.* at 89.

n11

[11]. 17 C.F.R. §240.13(d)-3(a) (2008).

n12

[12]. Brief of Amici Curiae, Intl Swaps and Derivatives Assn and Sec. Indus. and Fin. Mkts Assn, *CSX Corp. v. Childrens Investment Fund Mgmt. (UK) LLP*, 08 Civ. 2764, 64 (S.D.N.Y. 6-11-2008).

n13

[13]. *Id.* at 14-16.

n14

[14]. *See* Coach, Inc., Current Report (Form 8-K), (Feb. 7, 2008); Redwood Trust, Inc. Current Report (Form 8-K), (March 5, 2008); HRPT Properties Trust, Current Report (Form 8-K), (March 5, 2008); Sara Lee Corp., Current Report (Form 8-K), (March 27, 2008); Five Star Quality Care, Inc., Current Report (Form 8-K), (March 28, 2008).

n15

[15]. *See* Coach, Inc., Current Report (Form 8-K), (Feb. 7, 2008); Sara Lee Corp., Current Report (Form 8-K), (March 27, 2008).

n16

[16]. *See* Coach, Inc., Current Report (Form 8-K), at 3 (Feb. 7, 2008) (See Article 2, Section 12(a)(2)); Sara Lee Corp., Current Report (Form 8-K), at 2 (March 27, 2008) (See Article I, Section 10(a)(2)).

n17

[17]. *Id.*

n18

[18]. *Id.* *See also* Coach, Inc., Current Report (Form 8-K), at 3 (Feb. 7, 2008) (See Article 2, Section 12(a)(4)); Sara Lee Corp., Current Report (Form 8-K), (March 27, 2008) (See Article I, Section 10(a)(4)).

n19

[19]. Coach, Inc., Current Report (Form 8-K), at 3 (Feb. 7, 2008) (See Article 2, Section 12(a)(2)).

ABOUT THE AUTHOR(S):

F. Mark Reuter is a partner at Keating Muething & Klekamp LLP in the firm's Business Representation and Transactions Group which has overseen more than 300 deals in the past five years with an aggregate value in the billions of dollars. Mr. Reuter's practice focuses on corporate and securities law where he has extensive experience in securities regulatory matters, mergers and acquisitions and public and private offerings of debt and equity securities. His experience includes public offerings, follow-on equity offerings, investment grade and convertible debt offerings,

private placements and proxy solicitations.



19 of 19 DOCUMENTS

Emerging Issues Copyright 2008, Matthew Bender & Company, Inc., a member of the LexisNexis Group. All Rights Reserved.

Gotts and von Hehn on the Implications of Sovereign Wealth Fund Investments

2008 Emerging Issues 2315

Ilene Knable Gotts and Paul A. von Hehn on Sovereign Wealth Fund Investments--Risk of New Wave of Protectionism in the EU and the U.S.?

By Ilene Knable Gotts

June 2, 2008

SUMMARY: Ilene Knable Gotts and Paul A. von Hehn discuss the ramifications of sovereign wealth funds and how this type of investment vehicle is increasing the use of protectionist measures by the United States and the European Union. In their commentary, Gotts and von Hehn pay particular attention to the use of this investment vehicle in China and Russia.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Gotts, Ilene Knable, and von Hehn, Paul A. Sovereign Wealth Fund Investments--Risk of New Wave of Protectionism in the EU and the U.S.? LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

Flush with dollar-denominated funds accruing from booming commodities prices and trade surpluses with the United States, sovereign wealth funds (SWFs) the investment vehicles of resource-rich or export-heavy countries emerged during the second half of 2007 as an important and growing force in the U.S. equity investment and M&A arena and are also now beginning to make a significant impact on the European buy-out markets. n1 SWFs manage an estimated \$3 trillion in assets, a figure amounting to roughly 4% of global assets under management (as compared with 3% by hedge funds and 1% by private equity), n2 and in 2007, global investments by SWFs increased 165% to \$48.5 billion. n3 SWFs have been party to over a dozen major transactions in the U.S. since July 2007, including several multi-billion dollar infusions into some of the worlds largest financial institutions ailing from the subprime mortgage crisis. European and United States officials, however, have raised concerns regarding the increased level of SWF investment and the emergence of SWFs in countries such as China and Russia. Concerned that the investment decisions of such SWFs could be motivated or influenced by the strategic and political considerations of their respective governments (as contrasted with the mainly economic agendas directing pension and investment funds of countries such as Norway and Canada), government officials in both the United States and European Union have held high-level discussions regarding what actions, if any, should be undertaken concerning SWF investments in their respective jurisdictions.

SWFs the Basics

SWFs manage a diversified portfolio of domestic and international financial assets from a pool of resource or export-generated sovereign wealth. Sustained surpluses for the oil-producing and Asian economies provide reserves well beyond the needs of exchange rate management. ⁿ⁴ However, while SWFs are generally funded from accumulated foreign-exchange reserves in their sponsor countries, they are managed separately from the official reserves.

SWFs have been in existence for several decades: Kuwait launched the first SWF in 1953, ⁿ⁵ and in the 1970s, other Arab states began investing their newfound oil revenues through their own SWFs. ⁿ⁶ While SWFs originally existed in a few oil-rich Gulf states, today more than thirty countries maintain SWFs, twenty of which were formed after 2000. ⁿ⁷ The value of assets under management by SWFs has quintupled since 1990 to \$3 trillion, ⁿ⁸ and according to the International Monetary Fund (IMF) estimates, this value is expected to quadruple to approximately \$12 trillion by 2015. ⁿ⁹

The Abu Dhabi Investment Authority, the largest of the SWFs, manages, by some estimates, \$875 billion in assets ⁿ¹⁰; other large SWFs include two separate funds in Singapore (Temasek (\$160B) and GIC (\$330B)) ⁿ¹¹, Norway's Government Pension Fund (\$380B) ⁿ¹², the Kuwait Investment Authority (\$250B) ⁿ¹³, the Russian Stabilization Fund (\$160B) ⁿ¹⁴, the Qatar Investment Authority (\$50B) ⁿ¹⁵, the Korea Investment Corporation (\$20B) ⁿ¹⁶, and several affiliated funds in Dubai managing at least \$20 billion in the aggregate. ⁿ¹⁷ In 2007, China invested \$9.8 billion through 22 transactions to buy all or part of U.S. companies ⁿ¹⁸ and formed its own SWF, the \$200 billion China Investment Corp. (CIC). ⁿ¹⁹ CIC's fund is still only a fraction of the \$1.5 trillion in Chinese currency reserves, which are growing at a rate of about \$500 billion per year. ⁿ²⁰

With the slow-down of M&A activity by hedge funds and private equity firms and the liquidity squeeze since mid-2007, SWFs have played an important role in the recapitalization of critical U.S. financial institutions and have helped to strengthen the global banking system and the institutional financial system as a whole. Equity infusions from SWFs proved essential in helping several of the world's largest financial institutions quickly fill the multi-billion dollar balance sheet gaps that resulted from massive write-downs related to the subprime mortgage crisis. Abu Dhabi's \$7.5 billion infusion into Citigroup ⁿ²¹ marked the beginning of a series of SWF infusions into troubled banks that ultimately included UBS (by Singapore's GIC and an unidentified Middle Eastern investor) ⁿ²², Morgan Stanley (by China's CIC) ⁿ²³ and Merrill Lynch (by Temasek, in the first instance). ⁿ²⁴ Citigroup and Merrill each drew from the SWF pool twice, with Citigroup tapping several institutions including Singapore's GIC and the Kuwait Investment Authority for an additional \$12.5 billion in January of 2008; ⁿ²⁵ Merrill raised a total of approximately \$10 billion, initially from Singapore's Temasek and later from funds in Korea, Kuwait and Japan, amongst others. ⁿ²⁶

SWFs will likely continue to grow in size and number, thereby intensifying both the opportunities they offer and the public attention they receive. For an overview of SWF investment in the U.S., see *Sovereign Wealth Fund Investment in the U.S. Just Warming Up?*.

Why the Current International Scrutiny?

Is there a basis for governmental concern with sovereign foreign investment or is the political rhetoric simply the latest example of xenophobia? Given the tremendous benefits SWF investments offer to mature Western economies and corporations, it can be difficult to appreciate the growing concern they have elicited from Western government officials. From a business perspective, SWF investments offer a number of benefits, including long-term investment horizons and substantial tolerance for risk, absence of leverage, a stable capital base not subject to withdrawals, distributions or capital calls or other forms of flight risk, a perceived willingness to accept no- or low-governance arrangements, and, as several recent financial-sector investments illustrate, an ability to move capital quickly and in very large amounts as a source of liquidity for companies facing crisis or distress. From a regulatory perspective, countries around the world, particularly Western nations, already have decades of experience dealing with the delicate challenge of promoting and regulating foreign investment generally; moreover, there is a long global history of government investment in industry,

albeit by domestic governments (in Europe, governments even today own sizable positions in a number of major European corporations, as do several Asian governments in their respective domestic corporations, n27 and state-owned firms account for almost 80% of oil exploration and production throughout the world). n28

On the other hand, the sovereign ownership of these funds raises serious concerns in Western governments that SWFs will be managed to achieve the political or strategic goals of their respective sovereigns rather than for pure business purposes, thereby raising the risk that SWF activity will undermine confidence in or distort global capital markets. Both U.S. Democratic Presidential candidates have expressly raised these concerns. Senator Barack Obama recently indicated that if they are buying big chunks of financial institutions and their boards of directors influence how credit flows in this country and they may be swayed by political considerations or foreign policy considerations, I think that is . . . a concern. n29 Similarly, on foreign investment, Senator Hillary Clinton said SWFs must be more transparent, and called on the World Bank, the IMF and the U.S. Federal Reserve to provide better oversight and impose rules, indicating that she would like to see us move much more aggressively. n30 Senator Charles E. Schumer, Chairman of the Congressional Joint Economic Committee echoed this concern, noting that because they are government-owned, noneconomic factors may influence their decision-making and the pressure they put on companies that they own a piece of. n31 In Europe, Commission President Jose Manuel Barroso recently stated that [w]e cannot allow non-European funds to be run in an opaque manner or used as an implement of geopolitical strategy [by contrast, Norway's SWF] is often seen as the gold standard of sovereign wealth funds. We would like some others to look at [its] example and move towards the rigorous standards that [it is]. .. applying here. n32

SWF investments in certain companies may also raise national security concerns. n33 A principal worry is that a SWF investment could potentially give foreign government officials non-public and sensitive national security information. Targets may also have access to technology, natural resources, and critical defense expertise that could be important for national strategic interests. n34

Some commentators also contend that SWFs should have to compete on fair terms with private-sector investors by providing greater transparency regarding the value of assets under management, investment objectives and strategies, target portfolio allocations, risk management systems and internal controls. n35 Others posit the need for appropriate governance structures, such as guaranteeing a clear division of rights and responsibilities between sponsoring governments and SWF managers. n36

To some extent, SWFs have mitigated the potential concerns raised by governmental entities to date by ensuring that their investments in certain high-profile companies remain small and passive. More recent transactions, however, exhibit significant variation and financial sophistication, ranging from structured minority-no-governance equity infusions (*e.g.*, Citigroup, Advanced Micro Devices) to pre-IPO investments (*e.g.*, Blackstone, Och-Ziff) to strategic joint venture investments (*e.g.*, Bear Stearns, MGM Mirage) to full acquisitions (*e.g.*, Barneys). We would expect that as SWFs test the boundaries of economically and politically feasible transaction structures, we will witness more frequent and larger investments as overseas accumulations of commodities profits and foreign exchange reserves continue to be deployed. As the presence of such SWF investment increases in size and scope more systemic and uniform policies may be needed to balance the interests in maintaining the proper functioning of free capital markets and the national security concerns from foreign sovereign involvement in the economy.

Responses and Reactions in Europe

European Member States. The reaction in Europe to SWF investment can best be described as a struggle for a policy. The recent heightened investment activity by foreign firms with sovereign ownership has fueled a general fear of a sell-out of important strategic assets. Since the demarcation line between SWFs (and other forms of foreign investment) that may raise legitimate concerns and those that do not, is not always clear, the debate in Europe has very much focused on protection of public policy and public security interests.

The EU Commission was slow in reacting to the SWF investment uptake. Some Member States used this period of

uncertainty and indecisiveness as an opportunity to strengthen existing legislative measures against unwelcome foreign investment. Most European Member States have some form of legal mechanism to protect so-called strategic assets such as telecommunications, transport, defense, etc. from takeover by foreign entities. The critical issue from a community standpoint is whether such provisions are limited to foreign investments that raise public policy and public security concerns and thus are recognized exceptions from the EC Treaty's principle of free movement of capitalⁿ³⁷ or instead are broader and, therefore, protectionist.

For instance, until 2007, Germany did not have a special law protecting strategic assets. Rather, its Foreign Trade and Payments Act of 1961ⁿ³⁸ only provided the German government with the ability to stop transactions on national security grounds, a power that in practice, Germany had never invoked. Responding, however, to the dramatic increase in SWF transactions over the last several months, the German government recently agreed on a draft law that would establish an inter-ministerial commission similar in nature to the Committee on Foreign Investment in the United States (CFIUS) (see discussion below) that would be authorized to review and possibly veto acquisitions by government-controlled investment funds if they are seen to pose a risk for public order or national security. An acquisition of more than 25% in a German company could become subject to the review procedure under the new law, regardless of industrial sector. Key in the German debate and illustrative of the current mood in Europe is the composition of the inter-ministerial review commission. While the labor ministry, which had sought to allow the commission to block a deal if there was a risk of major job losses, will have consultative rights, the economics ministry, usually considered more liberal, will officially coordinate the new commission. The total composition of the commission will reportedly not be prescribed by law but instead be determined by non-public government-internal procedures.ⁿ³⁹

France makes the investment by foreign entities, whether SWFs or not, subject to governmental approval if the lesser of a controlling interest or a 33.3% share is acquired in certain sectors.ⁿ⁴⁰ Strategic sectors viewed as sensitive for the national interest include gaming, security, toxic agents for terrorist purposes, certain dual use technology, cryptology, etc. The EU Commission reportedly conducted an inquiry to determine if inclusion of some of these sectors by France was protectionist rather than within the public policy and public security exemption, but, to date, the Commission has not taken any specific action against France.ⁿ⁴¹ Focusing specifically on the SWF debate, the French government recently announced that it would introduce legislative measures so that its *Caisse des Dpts et Consignations*, which is essentially a SWF, could be used as defense weapon against investments by foreign funds including SWFs.ⁿ⁴²

Poland and other countries have golden share regimes for specific companies that reserve special veto rights for the government in case an investment or takeover in strategic assets is attempted. As a complement to these and other national measures, however, most Member States support the concept that there should also be a common European approach; otherwise circumvention would be too easy by using a country with light regulation as entry into the EU.

European Council and European Commission Response. The European Council and the Commission response at least at this stage provides for no new or specific EU legislation on SWF investments. At its spring meeting held on March 13 and 14, 2008, the Council endorsed a proposal made by the Commission in a Communication dated February 27, 2008 mandating a common European approach to Sovereign Wealth Funds.ⁿ⁴³ The Council specifically emphasized the EU's commitment to an open global investment environment based on the free movement of capital and supported the Commission's proposal to work with the Organisation for Economic Co-operation and Development (OECD) and the IMF to develop an international voluntary code of conduct to address a variety of areas, including rules on separating responsibilities within fund structures, to render fund investment decisions independent of politicians.ⁿ⁴⁴ The code would also provide for greater transparency through publication of an investment policy defining overall objectives, disclosure of general principles governing the relationship with the sponsoring government, and annual disclosure of investment positions and asset allocation, the use of loans, the size and source of the funds resources, and how the SWF exercises voting rights of stock it holds.ⁿ⁴⁵

By issuing the February 27 Communication, the European Commission seeks to avoid new protectionist measures by the Member States. In reaction to the debate and various legislative proposals discussed on a national level by Member States, it calls for a *common* European approach to ensure that a clear, predictable and reliable legal environment can be maintained. Moreover, the Commission clearly signals that SWF investments should be subject to the same rules and controls as other investments to which the EC Treaty's principles of free movement of capital between Member States and between Member States and third countries apply. Finally, the Commission Communication confirms the applicability of the European Court jurisprudence on the free movement of capital as developed in its decisions on Golden Shares. Referring to the European Courts 2002 decision concerning a Belgian Golden Share regime, the Commission explicitly states that any authorization system for foreign investment needs to comply with the principles of proportionality and transparency, and, in any event, any condition or restriction on foreign investment cannot be based on purely economic grounds. ⁿ⁴⁶ This approach seems to have the support of the European business community: the Business and Industry Advisory Committee to OECD issued a press release on March 31, 2008 warning that [g]overnments must avoid hastily conceived new regulations on sovereign wealth funds (SWFs) in their efforts to diminish recent rising public criticism against these investment vehicles. ⁿ⁴⁷

Some Consequences for Foreign Investment in Europe. Where does this opaque situation leave the foreign investor, whether SWF or not? On the institutional level, i.e., Council and Commission, there is clearly resistance to any legislative action that would impose new restrictions on foreign investment. On the national level, on the other hand, the diffuse fears albeit some of them legitimate over SWF investments have resulted in a flurry of political and legislative activity some of which could raise concerns of new protectionism.

This is where the Commission's February 27 Communication becomes critical and can prove to be helpful: legislative and other measures that Member States may adopt to deal with strategic investments by foreign entities, whether SWFs or not, need to comply with the principles developed by the European Court in its jurisprudence on Golden Share regimes. Specifically the Communication cites the European Courts 2002 decision upholding a Belgian regime and rejecting three other regimes based on a number of criteria to assess the compatibility of an authorization system with the EC Treaty's free movement of capital principles. These criteria include in particular a narrowly defined focus on specific strategic assets, strong procedural safeguards including subjecting the arrangements to judicial review, objective criteria by which the actions of the government could be measured, and strict time limits for any governmental action.

Thus, in principle, and notwithstanding the Member States prerogative for national rules to protect public policy and security interests, the Courts jurisprudence on the free movement of capital will be an important element in determining if a foreign investor (whether SWF or not) that is faced with undue restrictions or conditions, were to have any rights or recourse. Given, however, the often politicized context which frequently is the driver for such restrictions, legal arguments will likely be only one instrument of defense. As would not be unusual in these types of situations, legal arguments may have to be supported by other, less formal actions on the Member State and EU levels, something which requires familiarity and extensive expertise with the EU's internal procedures and processes.

U.S. Takes a Similar Approach, Albeit with a Strong Foreign Investment Regulatory Regime Already in Place

In addition to foreign ownership restrictions in several regulated sectors (*e.g.*, TV and radio stations, airlines), ⁿ⁴⁸ the United States, as well as many other jurisdictions, has had in place for a few decades laws that govern foreign investment in domestic companies that raise national security implications. The Committee on Foreign Investment in the United States (CFIUS) is a multi-agency body that oversees the national security review of transactions that may transfer control of a U.S. company or U.S. assets to a foreign entity. ⁿ⁴⁹ CFIUS has the power to make recommendations to the President as to whether to restrict a foreign acquisition on national security grounds. ⁿ⁵⁰ The Treasury Department regulations governing the CFIUS review process include a very open-ended definition of control

that can encompass a broad array of arrangements that may provide the power to determine, direct or decide matters affecting an entity. n51 Such a power can be either direct or indirect, and need not be actually exercised by the foreign party to meet the definition of control. These can include, for example, the ability to withdraw critical funding or the right to veto corporate actions that the minority foreign shareholder does not like. The regulations provide a safe harbor for certain purchases of voting securities solely for the purpose of investment. There are two applicable criteria: (1) to qualify as a purchase solely for the purpose of investment, the acquirer must have no intention of determining or directing the basic business decisions of the issuer; and (2) the acquisition will not be deemed to confer control only if, (a) the foreign person would hold ten percent or less of the outstanding voting securities of the U.S. person or (b) the purchase is made directly by one of several enumerated types of investment entities in the ordinary course of business for its own account, provided that a significant portion of that business does not involve the acquisition of entities. n52 Many of the recent investments in U.S. businesses by SWFs have been structured to fall within this investment only carveout, including Temasek's \$4.4 billion investment in Merrill Lynch (9.4% stake) n53 and CIC's \$5 billion investment in Morgan Stanley (9.9% stake). n54 Merely structuring an investment under the ten percent ownership threshold, however, will not necessarily provide comfort to transaction parties: the Treasury Department released proposed rules on April 21, 2008 that clarify that even foreign investments below 10% will not be immune from CFIUS review if they exhibit control or take any action inconsistent with acquiring or holding its interest solely for the purpose of investment. n55

In addition, in some circumstances, foreign investors may obtain large percentage equity stakes in U.S. businesses without CFIUS review by divorcing their equity stake from any ability to control the activities of the U.S. entity. For example, some foreign investors have acquired interests in U.S. businesses by investing in a limited partnership that has a U.S. person serving as the limited partner. n56 Whether these types of equity stakes constitute control will, however, depend on a careful evaluation of the structure of the investment vehicle and the foreign investors rights under the criteria indicated above.

CFIUS has an initial 30-day review period to determine whether to launch an additional 45-day investigation because the transaction threatens to impair the national security of the U.S. n57 In late 2007, Congress passed the Foreign Investment and National Security Act (FINSA) n58, which provides, in relevant part, that an extended review is presumed more likely when the transaction would result in foreign government control or in foreign control of critical infrastructure. n59 At the conclusion of the 45-day investigation, CFIUS will submit a recommendation to the President. n60 The President has 15 days from the date of referral to clear, prohibit, or suspend the transaction. n61

In the post-9/11 environment, concerns about sovereign foreign investment in U.S. domiciled companies has increased. For instance, CFIUS related concerns caused the abandonment of the 2003 proposed acquisition of Global Crossings fiber optic network by a consortium including Hutchison Whampoa Ltd of Hong Kong (which reportedly had ties to the Chinese military); n62 concerns regarding the timing and likelihood of obtaining CFIUS approval resulted in the ultimate withdrawal of China National Offshore Oil Corp.'s 2005 bid for Unocal; n63 CFIUS objections cratered the bid of Dubai Ports World, a state-owned company from Dubai to purchase Peninsular and Oriental Steam Navigation Company, a British firm holding the rights to manage cargo operations at major U.S. ports in 2006; n64 and, in late March 2008, CFIUS objections thwarted an attempt by China's Huawei Technologies (a telecommunications company reportedly with ties to the Chinese military) to buy 16.5 % of 3Com Corp. n65 As demonstrated by these recent examples, the involvement of foreign governments--especially governments that are not U.S. allies can be a critical consideration in obtaining CFIUS clearance.

Even against this backdrop of CFIUS enforcement, several U.S. lawmakers continue to raise concerns regarding SWF investments, particularly by China's SWF, the CIC. On February 7, 2008, for example, the US-China Economic and Security Review Commission held a hearing to examine the nature of SWFs in general and whether Chinese investments should be treated differently from other countries investments so as to protect national security. n66 The White House urged lawmakers to be very, very careful when considering legislation that could curb SWF investments, instead focusing on the need for SWFs to be transparent and seek economic, rather than political gains, from their investments. n67 On March 20, 2008, the Bush Administration announced that it had reached agreement with officials

from the Abu Dhabi Investment Authority and Singapore's Temasek to develop a set of best practices and had been granted assurance that these funds would not be employed to serve the political goals of their respective sovereigns. n68 Treasury Secretary Henry Paulson has stated that the United States welcomes sovereign wealth investment and looks forward to continuing to work with these two countries and others to support the initiatives under way at the IMF and the OECD to develop best practices for the funds and countries where the funds are making investments. n69 Secretary Paulson noted as well that one of the underlying principles for countries receiving the investment, however, is that they should not erect protectionist barriers to portfolio or direct investment. n70 Time will tell how well the U.S. and other major economies strike this fine balance.

Conclusion

The government attention being focused on SWF investments is a continuation of the increased focus on foreign investments generally, particularly in the post-9/11 environment. The heightened scrutiny afforded to transactions involving foreign investors, including SWFs, should be taken into account when evaluating a potential investment that might raise national security issues. To date, both European and U.S. regulators have limited their focus on SWFs to legitimate issues of national security and have not used the opportunity as a means for favoring domestic acquirers or engaging in protectionism more generally. However, while the CFIUS process in the U.S. outlines a relatively clear procedural path, in Europe, the possible combination of national legislation, Community principles of free movement of capital as interpreted by the European Court and political sensitivities can create a more complex process for both the target and the investor. Targets need to take into account the additional time and risk that may be associated with investments by foreign entities, particularly from countries that are not considered friendly at this time. Bids involving SWFs, for instance, may need to be more proactive in making commitments to address the risk of national security and economic concerns, including in the structuring of the post-investment governance of the target investment, particularly when competing against domestic bidders. In any event, transaction parties, whether in Europe or the U.S., should plan in advance to navigate through these foreign investment issues to minimize the potential for surprises and challenges to their transaction.

For more information on antitrust law, *see* Antitrust Laws and Trade Regulation, chapters 9 and 10 (Matthew Bender).

For more information on European Merger Control Law, *see* European Merger Control Law (Matthew Bender).

For more information on European Competition Laws, *see* European Competition Laws (Matthew Bender).

Return to Text

n1 * The authors recognize the significant contributions to this paper of Shaun J. Mathew, a corporate associate at Wachtell, Lipton, Rosen & Katz.

[1]. *See Sovereign wealth funds state investments on the rise*, DEUTSCHE BANK RESEARCH (Sep. 10, 2007), available at www.dbresearch.com.

n2

[2]. See *Asset-Backed Insecurity*, ECONOMIST.COM (Jan. 17, 2008), at 2, available at http://www.economist.com/opinion/displaystory.cfm?story_id=10533428.

n3

[3]. See Mark Kleinman, *Sovereign Funds Discover Gulf in Values*, TELEGRAPH.CO.UK (March 23, 2008), at 1, available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/03/23/ccswf123.xml>

n4

[4]. See David Lawsky, *EU to Consider Sovereign Wealth Fund Voluntary Code*, REUTERS (Feb. 23, 2008), available at <http://www.reuters.com/article/ousiv/idUSL2373561420080223>.

n5

[5]. See Sean OGrady, *EU to Agree Code of Principles for Sovereign Wealth Funds*, INDEPENDENT.CO.UK (Feb. 26, 2008), available at <http://www.independent.co.uk/news/business/news/eu-to-agree-code-of-principles-for-sovereign-wealth-funds-787357.html>.

n6

[6]. See James Surowiecki, *Sovereign Wealth World*, THE NEW YORKER (Nov. 26, 2007) at 1, available at http://www.newyorker.com/talk/financial/2007/11/26/071126ta_talk_surowiecki.

n7

[7]. See *A Common European Approach to Sovereign Wealth Funds*, COMMISSION OF THE EUROPEAN COMMUNITIES (2008) at 3, available at http://ec.europa.eu/commission_barroso/president/pdf/COM2008_115_en.pdf.

n8

[8]. See Ian Traynor, *Brussels Moves to Rein in \$3 Trillion Sovereign Funds*, GUARDIAN.CO.UK (Feb.

26, 2008) at 2, *available at* <http://www.guardian.co.uk/business/2008/feb/26/europe.economy>.

n9

[9]. *Id.*

n10

[10]. *See Asset-Backed Insecurity*, *supra* note 2.

n11

[11]. *Id.*

n12

[12]. *Id.*

n13

[13]. *Id.*

n14

[14]. *See Aggregate Amount of the Stabilization Fund of the Russian Federation*, Ministry of Finance of the Russian Federation, *available at* <http://www1.minfin.ru/en/stabfund/statistics/aggregate/>. On January 31, 2008, the Russian Finance Ministry created the growth-oriented \$32 billion National Welfare Fund out of funds from the Stabilization Fund. *See Russia to create 32-bln-dollar fund to support pensions*, Agence France Presse English Wire (January 31, 2008).

n15

[15]. *See Asset-Backed Insecurity*, *supra* note 2.

n16

[16]. See Korea Investment Corporation Official Website, *available at* <http://www.kic.go.kr/en/?mid=co01>.

n17

[17]. Dubai International Capital manages assets in excess of \$12 billion, *see* Statement Issued on Behalf of Dubai International Capital in the Context of the Recent Media Reports Referring to Citigroup, *available at* <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/03-05-2008/0004768773&EDATE=>, and Istithmar World, private equity fund controlled by the Dubai government, manages, by some estimates, manages a portfolio in excess of \$10 billion, *see* Istithmar buys 3% in London hedge fund, *available at* <http://archive.gulfnews.com/articles/07/06/25/10134738.html>.

n18

[18]. See *China On Course to be a Top US Investor*, MSN.COM (February 12, 2008) at 1, *available at* <http://news.moneycentral.msn.com/ticker/article.aspx?Feed=AP&Date=20080212&ID=8179627&Symbol=COMS>

n19

[19]. See Bob Davis, *Wanted: SWFs Money Sans Politics*, Wall Street Journal, Dec. 20, 2007, C1.

n20

[20]. See Christopher S. Rugaber, *China, Mideast Nations Now Big U.S. Investors: Political Backlash over Potential Security Threat*, SF GATE (Feb. 13, 2008), *available at* <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/02/13/BU9NV0VEN.DTL&hw=china+mideast&sn=002&sc=720>.

n21

[21]. See Robin Sidel, *Abu Dhabi to Bolster Citigroup with \$7.5 Billion Capital Infusion Government Investment Arm to Become a Top Holder, With Up to a 4.9% Stake*, Wall Street Journal, Nov. 27, 2007, A3.

n22

[22]. See David Reilly and Matthew Karnitschnig, *Bargain or Bailout? UBS Is the Latest to Seek Financial*

Aid in Asia, Middle East, Wall Street Journal, Dec. 11, 2007.

n23

[23]. See Andrew Edwards and Jed Horowitz, *Morgan Stanley Swings to Loss Amid Mortgage-Related Woes*, Dec. 19, 2007, available at <http://online.wsj.com>.

n24

[24]. See Jed Horowitz and Donna Kardos, *Merrill Lynch Cuts Deal with Temasek, GE as Firm Seeks to Shore up Capital*, Wall Street Journal, Dec. 25, 2007, A1.

n25

[25]. See David Enrich, Robin Sidel and Susanne Craig, *World Rides to Wall Streets Rescue*, Wall Street Journal, January 16, 2008, A1.

n26

[26]. *Id.*

n27

[27]. See James Surowiecki, *Sovereign Wealth World*, THE NEW YORKER (Nov. 26, 2007), at 2, available at http://www.newyorker.com/talk/financial/2007/11/26/071126ta_talk_surowiecki.

n28

[28]. See Justin Blum, *National Oil Firms Take Bigger Role*, Washington Post, Aug. 3, 2005, D01, available at http://www.washingtonpost.com/wp-dyn/content/article/2005/08/02/AR2005080201978_pf.html.

n29

[29]. See *US Lawmakers Want Tougher Stance on Sovereign Funds*, ARAB TIMES (Apr. 1, 2008) at 1,

available at <http://www.arabtimesonline.com/kuwaitnews/pagesdetails.asp?nid=12020&ccid=12>.

n30

[30]. See *The Invasion of the Sovereign-Wealth Funds*, ECONOMIST.COM (Jan. 17, 2008), available at http://www.economist.com/opinion/displaystory.cfm?story_id=10533866. See also Dana Cimilluca, *Hillary Clintons Foreign Investment Logic*, THE WALL STREET JOURNAL (Jan. 16, 2008), available at <http://blogs.wsj.com/deals/2008/01/16/hillary-clintons-foreign-investment-logic/>.

n31

[31]. See *Chuck Schumer on the Rise of Sovereign Wealth Funds*, BUSINESSWEEK (March 6, 2008) at 1, available at http://www.businessweek.com/magazine/content/08_11/b4075021424117.htm.

n32

[32]. See Rory Watson, *Europe Looks to Set Ground Rules for Sovereign Wealth Funds*, BUSINESS TIMES ONLINE (Feb. 27, 2008), available at http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3441120.ece.

n33

[33]. See Ilene Knable Gotts and Leon Greenfield, *Does the US Foster National Champions? Foreign Acquisitions and National Security*, GLOBAL COMPETITION REVIEW (2007), at 2.

n34

[34]. *Id.* at 2.

n35

[35]. See Carter Dougherty and Stephen Castle, *EU Warns Against Overreaction on Sovereign Wealth Funds*, INTERNATIONAL HERALD TRIBUNE (Feb. 25, 2008), at 2, available at <http://www.iht.com/articles/2008/02/25/business/fund.php>.

n36

[36]. See Philipp M. Hildebrand, *The Challenge of Sovereign Wealth Funds*, VOX (Jan. 21, 2008), at 2, available at <http://www.voxeu.org/index.php?q=node/881>.

n37

[37]. See Article 58.1(b)EC Treaty, available at http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf.

n38

[38]. BGBI I (Apr. 28, 1961), at 481.

n39

[39]. See Sven Afhppe, *Koalition legt Staatsfonds-Streit bei*, Handelsblatt (Apr 10, 2008), available at http://www.handelsblatt.com/News/Politik/Deutschland/_pv/doc_page/1/_p/200050/_t/ft/_b/1415322/default.aspx/koalition-legt-

n40

[40]. Financial and Monetary Code, Articles L151-153 and Decree 2005-1739 (Dec. 30, 2005), available at http://www.legifrance.gouv.fr/jopdf/common/jo_pdf.jsp?numJO=0&dateJO=20051231&numTexte=45&pageDebut=20779&pag

n41

[41]. See Commission press release, IP/06/1353 (Oct. 12, 2006), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/1353&format=HTML&aged=1&language=EN&guiLanguage=en>.

n42

[42]. French Presidency press conference (Jan. 8, 2008), summary available at http://www.premier-ministre.gouv.fr/chantiers/reforme_institutions_848/chef_etat_detaille_sa_58884.html.

n43

[43]. See Commission of the European Communities, *supra* note 7.

n44

[44]. Presidency conclusions, 7652/08 at 36, available at http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/99410.pdf.

n45

[45]. See Commission of the European Communities, *supra* note 7.

n46

[46]. C-503/99, *Commission v Belgium*, [2002] ECR I-4809.

n47

[47]. Available at http://www.biac.org/comms/releases/80331_BIAC_press_release_SWFs-final.pdf.

n48

[48]. See Ilene Knable Gotts and Leon B. Greenfield, *Telecom Without Borders? The Impact of US Pre-Merger Regimes*, *Competition Law International* (Oct. 2006) at 40.

n49

[49]. See Ilene Knable Gotts, Leon B. Greenfield, and Perry Lange, *Is Your Cross-Border Deal the Next National Security Lightning Rod? Identifying Potential National Security Issues and Navigating the CFIUS Review Process*, 16 *Business Law Today* (July/August 2007) at 32.

n50

[50]. *Id.* at 33.

n51

[51]. 31 C.F.R. § 800.204 (existing regulation); *see also* Leon B. Greenfield, Ilene Gotts, and Timothy Schnabel, *Caveat Emptor: the Long Tentacles of Control Under Exon-Florio Act Can Surprise the Unwary*, 11 *Mergers & Acquisitions Law Reporter*, 267 at 268 (Apr. 7, 2008) available at <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.15477.08.pdf>.

n52

[52]. Leon B. Greenfield, Ilene Gotts, and Timothy Schnabel, *supra* note 51.

n53

[53]. *See* Jed Horowitz and Donna Kardos, *Merrill Lynch Cuts Deal with Temasek, GE as Firm Seeks to Shore up Capital*, THE WALL STREET JOURNAL, Dec. 25, 2007, at 1, available at <http://online.wsj.com/article/SB119850086138148639.html>.
[<http://www.marketwatch.com/news/story/singapore-invesment-company-temasek-reports/story.aspx?guid=%7BD7B39057-3EC>

n54

[54]. *See* Andrew Edwards and Jed Horowitz, *Morgan Stanley Swings to Loss Amid Mortgage-Related Woes*, THE WALL STREET JOURNAL, Dec. 19, 2007, at 1.

n55

[55]. Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons (proposed April 21, 2008) (to be codified at 31 CFR Part 800) at 47, 54-55 (§§ 800.223, 800.302(c)), available at http://www.treas.gov/press/releases/reports/proposed_regulations42108.pdf; *see also* *Proposed Treasury Regulations Provide that Small Investments in U.S. Firms May Be Subject to CFIUS Review*, available at www.wlrk.com/docs/proposedFINSAreulations.pdf.

n56

[56]. Leon B. Greenfield, Ilene Gotts, and Timothy Schnabel, *supra* note 51, at 3.

n57

[57]. Ilene Knable Gotts, Leon B. Greenfield, and Perry Lange, *supra* note 49, at 33.

n58

[58]. Foreign Investment and National Security Act of 2007 (FISIA), Pub. L. 110-49; *see also* Lynn Charytan and Leon B. Greenfield, *The U.S. CFIUS Foreign Investment Review Process: A Regime in Flux*, 2008 Competition Law and Policy Forum, Langdon Hall, Cambridge, ON, WilmerHale, Feb. 6-8, 2008, at 1.

n59

[59]. Lynn Charytan and Leon B. Greenfield, *supra* note 58, at 9. The proposed regulations define critical infrastructure as systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular systems or assets of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security. Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, *supra* note 55 at 40 (§ 800.207).

n60

[60]. Ilene Knable Gotts, Leon B. Greenfield, and Perry Lange, *supra* note 49, at 33.

n61

[61]. *Id.*

n62

[62]. *Id.*

n63

[63]. Gotts and Greenfield, *supra* note 33, at 39.

n64

[64]. Charytan and Greenfield, *supra* note 58, at 7.

n65

[65]. *See* Greenfield, Gotts and Schnabel, *supra* note 51, at 267.

n66

[66]. *See* Hearing on China's Views of Sovereignty and Methods of Access Control, Feb. 27, 2008, U.S.-China Economic and Security Review Commission, *www.uscc.gov*, available at http://www.uscc.gov/hearings/2008hearings/hr08_02_27.php.

n67

[67]. *White House urges caution on foreign investment curbs*, AFP, Feb. 7, 2008, available at <http://afp.google.com/article/ALeqM5ievh5HGaovmmfMDPjjrq5ApwtbOA>.

n68

[68]. *See* Martin Crutsinger, *Sovereign Wealth Funds Discussed*, SFGATE (Mar. 20, 2008), at 2, available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2008/03/20/national/w124056D25.DTL>.

n69

[69]. *Id.*

n70

[70]. *Id.*

ABOUT THE AUTHOR(S):

Ilene Knable Gotts, a member of Wachtell, Lipton, Rosen & Katz's Antitrust Department, represents and counsels clients on a range of antitrust matters, particularly those relating to mergers and acquisitions. Ms. Gotts began her career as a staff attorney in the Bureau of Competition of the Federal Trade Commission in conduct and merger investigations, and in the Federal Trade Commission Bureau of Consumer Protection.

In 1995, Ms. Gotts served as the President of the Washington Council of Lawyers. She was the Chair of the Antitrust and Trade Regulation Section of the Federal Bar Association from 1995-1997. An active participant in the Section of Antitrust Law of the American Bar Association, Ms. Gotts is currently the Vice Chair and will be the Chair of the Section in 2009-2010. She previously served as the International Officer and the Chair of the Antitrust Section's Task Force on the Merger Review Process, and as a member of the International Task Force, as well as the Chair on the Section's Mergers Committee, and Vice Chair of the Intellectual Property Committee. In 2006 -- 2007, Ms. Gotts was the chair of the Antitrust Section of the New York State Bar Association. Ms. Gotts is regularly recognized as one of the world's top antitrust lawyers, including being recognized in both the 2006 and 2007 Editions of The International Who's Who of Business Lawyers, as one of the top 15 global competition lawyers, in the first tier ranking of Chambers USA Guide, and the "leading individuals" ranking of PLC Which Lawyer Yearbook 2007 Edition.

Ms. Gotts edited both the second and third editions of the ABA's treatise on the Antitrust Merger Review Process and has had published over 120 articles on antitrust issues relating to mergers and acquisitions and Hart-Scott-Rodino compliance. She also is a frequent lecturer on antitrust topics. She serves on the advisory boards of Antitrust and Trade Regulation Report, Antitrust Counselor and Antitrust Report.

Paul A. von Hehn is a partner in WilmerHales Corporate and Transactional and Regulatory and Government Affairs Departments, and a member of the Aviation, Communications, and German Corporate Practice Groups. He joined the firm in 1990.

Mr. von Hehn has extensive international experience, having practiced in Belgium, Germany, Hong Kong and China, and the United States. He has also worked on numerous projects in the emerging economies of Central and Eastern Europe, including CIS and Russia. Mr. von Hehn's practice ranges from corporate and international transactions to compliance, including investigations and corporate governance issues.

Mr. von Hehn's practice has a strong focus on regulated industries with particular experience in the telecoms and aviation sectors. He has helped companies structure complex international M&A and joint venture transactions and has pioneered prominent industry alliances in the communications and aviation sectors.

He has represented fixed and mobile telecommunications operators, advising them on network sharing arrangements and international strategic alliances to broaden their footprints, as well as providing strategic advice on the "conversion" issues related to the Internet, IT and the relationship to the media industry in general.

Mr. von Hehn's aviation experience covers various airport projects and airline transactions including the Star Alliance, as well as modernization projects for air traffic control systems in several countries. He led a multidisciplinary team that wrote the legislative "blueprint" that became the legal framework of the "Single European Sky."

He assists European companies that are faced with regulatory and reputational issues as a result of allegations of non-compliance ranging from corruption, including FCPA, accounting fraud and money laundering, to other regulatory issues of non-compliance, including those arising under REACH. He has conducted compliance reviews and internal investigations for clients, including handling of the relationships with the investigating authorities.

Mr. von Hehn was a visiting instructor at the Rome-based International Development Law Institute (IDLI) and taught courses on concessions, joint ventures and infrastructure investments in the telecommunications and transport sectors. He has written and spoken on telecommunications topics, developments in European Community law, US banking and securities laws, China developments, and corporate investigations and compliance.

Expert Commentary is the title of this LexisNexis publication. All information provided in this publication is provided for educational purposes only and use of the term Expert Commentary is not intended to describe or designate the authors qualifications as a lawyer or in a subspecialty of the law. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.