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The "Downturn" Roadmap: Parsing the Shift in Deal Terms

By William Regner, Jeffrey Rosen, and Kevin Rinker, Partners of Debevoise & Plimpton LLP

It is no secret that the past few years have seen a global glut in capital, the emergence of mega buyout funds and an unprecedented string of private equity acquisitions of public companies. So striking were these events that it is easy to forget that, not so long ago, acquisitions of publicly traded companies by sponsors were relatively infrequent. Rather, strategic buyers were routinely thought to be able to pay more—both because they could benefit from synergies and because they had a lower cost of capital (both equity and debt). Further, private equity's need for third-party debt financing seemed to make a sponsor-led transaction riskier for the target company than a sale to a strategic acquirer. And many private equity firms were initially reluctant to run the risk of buying companies with no post-closing indemnification or recourse.

An extraordinary wave of inexpensive, readily committed and easy-to-live-with acquisition financing changed all that. Moreover, as overheated auction followed overheated auction, there was a rapid evolution in certain key terms of acquisition agreements—an evolution widely reported to have illustrated the increasing leverage of sellers and targets as they negotiated with ever more eager private equity purchasers. In fact, now that the music appears, at least temporarily, to have stopped, it is far from clear that the deal technology resulting from this evolution is as seller friendly as was originally thought.

Here we chart, at some level of generality, the shift in deal terms relating to financing conditions, recourse, reverse break-up fees and related provisions that occurred during the recent boom years and sketch some of the questions that arise under the principal forms of agreement that seem to have resulted.

Disappearance of the Financing Condition

In the beginning (that is, prior to 2004 or so), nearly every private equity deal included a financing condition and was accompanied by debt commitment letters that had been negotiated by the sponsor and, thereafter, by the target, which was seeking to reduce conditionality and to line up what conditions were included with those in the underlying acquisition agreement. Over time, sponsors and targets were increasingly successful in reconciling the conditions—that is, typically material adverse change (MAC) conditions in financing agreements came to mimic those in the merger agreement, "market outs" or "market MACs" were eliminated from financing commitments, and much other language thought to provide the lenders with "wiggle room" was eliminated. Similarly, provisions evolved that required the sponsor to draw down on the financing, including any bridge facility, some period after the other closing conditions were satisfied (a period that evolved into a marketing period beginning once the target provided required financials and other information to market the bonds).

The result was a set of documentation under which the sponsor had a financing out, fully committed financing and a firm obligation to draw on that financing if the conditions to closing were satisfied—an obligation that

TABLE OF CONTENTS

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could in theory be specifically enforced. Often, this documentation was signed on the sponsor's behalf by an acquisition shell with no assets other than the debt commitments and an equity commitment from the sponsor—a commitment that could not be drawn on unless all conditions to closing (including the availability of debt financing) were satisfied, and with respect to which the target might or might not be designated as some kind of third-party beneficiary. Further, the extent to which sponsors in fact observed corporate formalities with respect to the acquisition shell varied from deal to deal, so there was at least some uncertainty as to whether a sponsor could be secure in hiding behind its impecunious shell subsidiary.

The result was a somewhat curious mosaic—the financing out worried targets and did seem to create some uncertainty, although that was to a considerable degree mitigated by the tight commitment letters and the requirement that the buyer draw on the financing. On the other hand, the buyer had no assets other than commitments, which were conditioned on the financing as well, and as to which the target's rights were murky. But the sponsor was not entirely confident relying upon the buyer's shell status, both as a legal matter and because, as sponsors frequently pointed out, there could be significant reputational damage attendant to walking away from a deal and escaping liability on the ground that the shell company had no assets anyway.

Partly because it was complex and confusing, and partly because it did inject some uncertainty into the situation, this form of documentation put private equity firms at a disadvantage to strategic buyers, which rarely required a financing condition. And once the ready availability of debt capital—marked by historically low interest rates and innovations such as "covenant lite" loans (that is, containing no maintenance covenants) and PIK toggle notes (notes allowing the buyer to issue additional notes in lieu of making interest payments)—enabled private equity firms to compete favorably with strategics on price, they came under pressure to eliminate conditionality.

The result was the disappearance—almost overnight it seemed—of the financing condition. That had collateral consequences as well: commitment letters were tightened further (indeed, skeptics may well wonder whether sponsors were as keen to eliminate commitment letter conditionality during the time they knew their acquisition agreement would include a financing out); the requirement to draw the financing and close became more specific, as did the provisions requiring an adequate period to market the debt before bridge financing had to be drawn; and sponsors sought to limit their exposure in the event lenders failed to fund the debt—whether in clear breach of the commitments letters or as part of a bona fide dispute as to whether conditions to closing had been satisfied.

Rise of the Reverse Termination Fee

The latter urge led to the creation of the "reverse termination fee," which began life as a fee payable to the target/seller in the event the deal did not close because the financing was not available, but quickly evolved into a broader limitation on liability if the transaction did not close for any reason (although sometimes the fee was higher if it failed to close for reasons other than unavailability of financing). Naturally, once the negotiations zeroed in on a termination fee, the discussion turned to mechanisms to ensure that an entity with substantial assets would be on the hook to make the payment, and funds began to guarantee payment of any reverse termination fee that became due. But no self-respecting sponsor was willing to offer its fund's coffers without very clear language to the effect that the termination fee (or some negotiated maximum damage amount) was the sole amount for which the fund could be liable.

That left one final piece of the puzzle for negotiation—the extent to which the sponsor should be free to walk from the deal upon payment of the reverse termination fee. While the sponsor was clearly not supposed to be liable for an amount in excess of that fee, it was less obvious that entire agreement should effectively be converted to an option. Practice on this point has varied. Some agreements made it clear that the termination fee really is the only remedy and that the acquisition agreement is nothing more than an option. Others were a bit unclear, containing specific performance language and exclusive remedy language that were not entirely consistent. And a third group provided that the target could specifically enforce the obligations to draw the financing and close but that the fee (or perhaps some higher damage limit) capped the damages for which the sponsor could be liable if the transaction did not close.

The "New World" Consequences for Sellers

So what did all this actually accomplish for sellers?

In the past, sellers took some risk that the financing would not be available, but if all conditions were satisfied, it would be a highly risky matter for the private equity firm—or the financing source—to decide not to close. The target retained the ability to seek specific performance against the acquisition vehicle, including the possibility that a court would require the shell specifically to enforce its debt and equity commitment letters against the lenders and the private equity fund or, indeed, that a court would conclude that the private equity fund was in any event the real party in interest.

In contrast, the new form of documentation, except perhaps where a specific performance remedy has been clearly preserved, has effectively given private equity sponsors an option to walk for a fee that is often in the range of 2-3% of deal size. That may be scant comfort to sellers, particularly where markets are choppy or business challenging, and clearly creates the possibility that buyers and lenders will renegotiate deal terms—including purchase price—after signing, either in response to escalating credit costs or in an effort to obtain relief from business problems that do not rise to the level of a MAC. At the same time, lenders, facing deteriorating secondary markets and more firmly on the hook than ever to fund their commitments, have a powerful incentive to pressure the private equity firms to renegotiate their deals.

The result: a three-way food fight that may be coming soon to a deal near you. How those fights sort themselves out may determine whether the pendulum swings back to the traditional use of financing conditions—and also whether private equity firms will continue to be able to compete effectively with strategic acquirers for public company deals.

The "Downturn" Roadmap: A European Perspective

By Peter King, a Partner of Shearman & Sterling LLP, London

When America sneezes, Europe catches a cold. Many of trends to which the authors of the prior article refer have been repeated in the European M&A market over the past few years. But there are two important differences between US and European practice which affect the way these trends have impacted European deals. These relate to the requirement for "certain funds" in bid situations—and the limited protection available in many situations against material adverse changes in the business of the target.

Requirement for "Certain Funds" in Bid Situations

The requirement for "certain funds" originates from UK public takeover practice. Since its inception, one of the key principles applied by the UK Takeover Panel has been that an offeror should only announce an offer after ensuring that it can fulfill any cash consideration it is offering. This principle now requires bidders to obtain independent confirmation of their ability to pay cash consideration for the shares they are trying to buy before announcing a takeover offer.

This confirmation is usually provided by the bidder's investment bank advisers, and—if those advisers do not undertake adequate due diligence—they may be required to pay the cash themselves. Around these requirements a practice has developed of signing definitive loan agreements and dealing with all conditions precedent to drawing of finance before a deal is agreed and announced.

Although the "certain funds" requirement started in the UK, it now applies by law (with certain local variations) to takeovers of public companies in all European Union countries. Increasingly, sellers are often insisting on a similar confirmation in private company transactions too—although there is no legal requirement for it.

Limited Protection for Target's Material Adverse Changes

The other issue is more specific to the public takeover market in the UK. Again, following the lead of the UK Takeover Panel, European regulators strictly limit the extent to which an offeror can rely on material adverse changes in the business of the target to allow it to withdraw from a takeover offer. The UK Takeover Panel will effectively only allow reliance on such a condition (however widely it is drafted from a legal point of view) if there has been a change of such a significant nature so that the whole commercial basis of the deal has disappeared. In one famous case relating to a takeover of an advertising company, the downturn in advertising revenues following the events of September 11th was judged to not be such a change, and the bidder was compelled to complete its offer.

As a result, private equity buyers of European targets are rarely at a disadvantage to their strategic counterparts simply because of financing issues—the only question being whether a strategic buyer can reach the "certain funds" stage more quickly than a private equity buyer whose financing may be more complex. Private equity buyers will often employ relatively simple bridge financing to avoid this problem. The "reverse termination fee" tends to be restricted to situations in which a deal may fail because of antitrust or other regulatory concerns affecting the purchaser.

What Does "Material" Mean?

By Kenneth Adams, a consultant and speaker on contract drafting and author of "A Manual of Style for Contract Drafting." His site and blog are at AdamsDrafting.com.

A Source of Ambiguity

According to *Black's Law Dictionary,* one meaning of "material" is "of such a nature that knowledge of the item would affect a person's decision-making process." (In this article, this meaning is referred to as the "affects a decision" meaning.) This meaning has been embraced in the leading case on materiality in an M&A context, *IBP, Inc. v. Tyson Foods, Inc.,* 789 A.2d 14 (Del. Ch. 2001). In an M&A context, and from the buyer's perspective, this meaning of "material" refers to information that would have caused the buyer not to enter into the agreement or would cause the buyer not to want to close the transaction. Think "dealbreaker."

But another meaning of "material" is "significant," in other words important enough to merit attention. This meaning would encompass a broader range of significance than the "affects a decision" meaning—for something to be material to a contract party, it would simply have to be of more than trivial significance.

In any given provision, such as the representation "Acme's books and records contain no material inaccuracies," either meaning could conceivably be intended. In other words, "material" is ambiguous.

Which meaning was intended in any given provision would have significant implications. For example, a buyer and its counsel might assume that any non-trivial nondisclosure with respect to a given representation containing a "material" qualification would be sufficient to render the representation inaccurate. By contrast, a court could well hold that for purposes of that representation, "material" conveys the "affects a decision" meaning. That could result in the buyer's not being entitled to be indemnified for inaccuracy of that representation unless the seller's nondisclosure happened to meet the high standard associated with that meaning.

How "Material" Is Used

Given that cases addressing materiality invariably invoke the "affects a decision" meaning, one would be entitled to wonder whether this ambiguity is more apparent than real. But corporate practitioners use the word "material" so often in drafts and in negotiations as to make it difficult to conceive that each time they do so they have in mind a dealbreaker level of significance. And indeed, two bits of evidence suggest that regardless of the case law, in many contexts drafters do in fact have in mind the "important enough to merit attention" meaning when they use the word "material."

First, attributing the "affects a decision" meaning to the word "material" would often strip a provision of much of its utility. Consider the following example: A credit agreement requires the lender to deliver certain forms unless doing so would "result in the imposition on the Lender of any additional material legal or regulatory burdens, any additional material out-of-pocket costs not indemnified hereunder, or be otherwise materially disadvantageous to the Lender." It's unlikely that in this case the lender had in mind that it would be reimbursed only if the burdens, costs, and disadvantages imposed on the lender were sufficiently significant that it wouldn't have made the loan if it had known about them.

The second bit of evidence suggesting that drafters do in fact have in mind the "important enough to merit attention" meaning of "material" is that in some contexts one cannot, as a matter of semantics, say that "material" conveys the "affects a decision" meaning.

Consider the following representation: "The Seller is not in default under any material contract to which it is party." The knowledge imparted by this representation relates to defaults under contracts to which the seller is party rather than to the contracts themselves. Consequently, it wouldn't make sense to modify the phrase "contract to which it is party" (as opposed to, say, the word "default") with the word "material" if it's meant to convey the "affects a decision" meaning. In this context, "material" could only mean "important enough to merit attention."

Courts and practitioners appear to accept that when used in the phrase "material adverse change," "material" conveys the "affects a decision" meaning—any party invoking a MAC provision would need to make a strong showing. But in any other context, either meaning of "material" could conceivably be the one intended. Although context might suggest that one or other meaning is intended, from a semantics perspective one cannot know for sure, as agreements invariably fail to specify which meaning is intended.

Defining "Material"

The clearest way to eliminate this ambiguity would be to use two different labels for the two meanings. This article proposes that you use "material" to convey the "affects a decision" meaning and use "significant" to convey a broader range of significance.

But if you wish to use "material" to convey the "affects a decision" meaning, you should make that meaning explicit, so as to purge "material" of its ambiguity. You would also need to make clear whose perspective applies for purposes of determining materiality. In *IBP, Inc. v. Tyson Foods, Inc.*, the court considered materiality from the perspective of the "reasonable acquiror"; for this approach to apply in any context, one would need to refer to the perspective of a reasonable person in the position of the party in question.

To incorporate these concepts into the meaning of "material," it would be best to use it as a defined term. You might find it useful to also define "materially"—as a matter of logic it's a better fit than the phrase "material adverse change" for purposes of the bringdown condition.

The exact definition of "Material" would depend on the context and on which parties are covered by the definition. The following definition of "Material" would apply to the buyer in an M&A transaction: "'Material' and 'Materially' refer to a level of significance that would have affected any decision of a reasonable person in the Buyer's position regarding whether to enter into this agreement or would affect any decision of a reasonable person in the Buyer's position regarding whether to consummate the transaction contemplated by this agreement."

Defining "Significant"

As for using "significant" to convey the "important enough to merit attention" meaning of "material," there is precedent for according "significant" this broader meaning. For example, in connection with guidance on evaluating internal controls, the Securities and Exchange Commission recently defined the term "significant deficiency" to mean a deficiency "that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." (See SEC Release No. 33-8829.)

But given that "significant" is a vague word, it would be best to make it explicit that the broader meaning is intended, and the best way to do that would be to create a defined term for "significant," as in "Acme's books and records contain no Significant inaccuracies."

This article proposes the following definition: "'Significant' means important enough, from the perspective of a reasonable person in the Buyer's position, to merit attention, and it includes a lesser level of significance than does the defined term 'Material.'"

Through contrast with the definition of "Material," this definition specifies that in a relative sense the broader meaning is intended. And it does so in an absolute sense, too, by offering "important enough to merit attention" as the lexical definition of "significant."

You might want to define "insignificant" too, for use in provisions such as "Any inaccuracies in Acme's books and records are Insignificant." You could define "Insignificant" with "Significant," or you could define it separately as follows: "'Insignificant' means not important enough, from the perspective of a reasonable person in the Buyer's position, to merit attention."

As with the "affects a decision" meaning, the broader meaning of "material" raises the question of whose perspective applies for purposes of determining whether or not something is important enough to merit attention. That issue is addressed in the proposed definitions.

Limiting Use of Qualifications

Whether to make a representation, obligation, or condition subject to a "Material" or "Significant" qualification is essentially a function of each party's bargaining power. A buyer would always prefer to give a qualification using "Significant" rather than "Material."

Of the two standards, qualifications using "Significant" seem more dispensable. They would seem prone to arbitrariness, given the low threshold involved. And any party could reasonably claim that if it's willing to go to court to recover damages that it claims arose from, for example, inaccuracy of a representation subject to a qualification using "Significant," then by definition the standard was met. So you might instead want to avail yourself of bright-line alternatives, for instance by keying a given qualification to a threshold monetary value or matters listed on a schedule. Or you might want to dispense with a given "Significant" qualification.

More generally, you could omit some or all qualifications relating to importance—whether using "Material," "Significant," or more precise alternatives—if you incorporate a materiality qualification in the seller's bringdown condition and make any seller indemnification obligations subject to a basket. Doing so should eliminate any concern on the part of the seller that giving a flat representation could result in the transaction's not closing due to, or result in that party's incurring liability for, a relatively minor inaccuracy.

Basic Protection

If you're reluctant to adopt wholesale the admittedly novel definitions recommended in this article, here's a more rudimentary way to avoid coming to grief due to the ambiguous "material": Use "material" only to convey the "affects a decision" meaning. Use bright-line alternatives to express a lesser level of significance. And where circumstances permit, dispense with qualifications relating to importance.

Four Things Buyers Need to Know About Successor Liability

By John J. Jenkins, a Partner of Calfee, Halter & Griswold LLP

Asset purchase transactions are often cumbersome. Negotiating and drafting an asset purchase agreement is frequently a quite involved process, and the mechanics of transferring individual assets at closing can be very complicated and time consuming. What often makes these additional burdens worthwhile to an asset buyer is the perceived ability to pick and choose which assets and which liabilities it wants.

The good news for asset buyers is that their perception usually matches reality: an asset buyer generally assumes only those liabilities that it agrees to take in the purchase agreement. The bad news is that is not always the way that it works out. Successor liability is a real concern, but the bigger concern is that even if the buyer's management understands the possibility of successor liability, they may not fully appreciate the extent and nature of the risk. If they do not, then that risk may not have been appropriately reflected in the pricing negotiations, and the buyer may well be left without the benefit of the bargain that it thought it made.

Discussions about successor liability doctrines can be pretty mind-numbing from a client's perspective, but they don't have to be. That's because even though successor liability is a complex area of the law, what buyers need to keep in mind about successor liability in most deals can be distilled into the following four points:

- Successor liability is not just about product liability
- There's more to successor liability than just common law
- Bankruptcy isn't a magic bullet
- Federal law is a whole different world

If buyers and their advisors keep these four points in mind during the due diligence and negotiation process, they can help significantly reduce the likelihood of mispricing a deal based on a faulty risk assessment.

1. **<u>It's Not Just about Product Liability</u>—**In addition to express or implied assumption of liability and situations involving fraud, traditional common law exceptions to the general rule of successor non-liability include the "de facto merger" doctrine, which covers stock for assets deals involving substantially all of a corporation's business, and the "mere continuation" doctrine, which covers "corporate reincarnations" usually involving inadequate consideration and identity of ownership. In the past several decades, these doctrines have been expanded in a number of states through the adoption of "product line" or "expanded mere continuation" theories that have done away with many of the more stringent requirements applicable to traditional common law tests.

   Most of the common law successor liability doctrines grew up around product liability, and expansion of these doctrines tends to come in that area as well. Product liability has been the engine driving common law successor liability because that's where most of the claims arise, and where the plaintiffs are the most sympathetic—often people injured by a defective product.

   Generally speaking, however, these doctrines are <u>not</u> limited to product liability cases. For example, Ohio courts have applied the various tests for successor liability in a number of non-products liability tort claims, including trespass, *Pavkov v. Time Warner Cable*, 2000 Ohio App. LEXIS 1485 (Wayne Cty. 2000), and fraud and negligence, *Aluminum Line Products v. Brad Smith Roofing*, 109 Ohio App. 3d 246 (Cuyahoga Cty. 1996). The tests also have been applied to contract claims. *Welco Industries, Inc. v. Applied Cos.*, 67 Ohio St. 3d 344 (1993).

2. **<u>There's More to Successor Liability than Common Law</u>**—Most states have enacted statutory provisions that impose responsibility for certain obligations of a predecessor directly on a successor entity. These statutory obligations extend beyond those imposed by bulk sales laws or statutes codifying common law successor liability doctrines (such as fraudulent transfer statutes), and include statutes imposing direct responsibility on a buyer for obligations to the government that a seller has not satisfied.

   Under many state statutes, an asset purchaser may face liability for a variety of taxes and governmental charges, including a seller's unpaid sales taxes (see, *e.g.,* Mo. Rev. Stat §144.150), unemployment insurance premiums (see, *e.g.,* Maine Rev. Stat. tit. 26 §1228), and corporate franchise taxes (see, *e.g.,* Ohio Rev. Code §5733.18). Buyers seeking to obtain assurance that they will not be exposed to liability may generally seek a tax clearance certificate from state authorities, but these are not always available in a timely fashion. Alternatively, or as a supplement to these arrangements, escrow provisions or other purchase price holdbacks may be sought in order to protect the buyer from these obligations.

3. **<u>Bankruptcy Isn't a Magic Bullet</u>**—Bankruptcy law is generally regarded as preempting state successor liability provisions, but it is not the magic bullet that many purchasers perceive it to be. Successor liabilities may arise notwithstanding a sale order because of jurisdictional issues relating to the scope of the protection provided by the bankruptcy process, due process concerns involving notice and an opportunity to be heard by potential claimants, and whether or not the remedy sought is a "claim" discharged by a bankruptcy court's sale order.

   Successorship issues in bankruptcy are not limited to asset transactions, but it is here where they are often most acute. The problem arises in part from the language of the statute dealing with asset sales. Section 363 of the Bankruptcy Code authorizes a trustee to approve a sale of the debtor's assets, but Section 363(f) of the statute says that such a sale is free and clear only of "interests" in property. This language is not as broad as the operative provisions governing plans of reorganization under Chapter 11, which provides that any property dealt with by the plan is "free and clear of all claims and interests of creditors."

   The discrepancy in language between the two statutory provisions has led some courts to conclude that a claim must be reduced to an interest in the debtor's property before it can be foreclosed. Accordingly, some courts have interpreted Section 363(f) to permit pre-bankruptcy claims that have not been reduced to a judgment to survive the sale order and to be asserted against the buyer. *Zerand-Bernal Group, Inc. v. Cox*, 23 F3d 159 (7th Cir. 1994).

   A prudent buyer in a Section 363 sale may take several actions to maximize the protection against successor liability provided by the bankruptcy process. For example, the buyer may take steps to ensure that adequate notice is given to as broad a class of potential claimants as possible, thus mitigating against due process based arguments. In addition, because the bankruptcy court's equitable power has been held to extend beyond the language of Section 363 itself, a buyer may also seek language in the sale order expressly finding that the sale of assets is free and clear of any claims.

4. **Federal Law is a Whole Different World**—Of course, questions concerning the responsibility of a buyer for a seller's activities do not just arise under common law or state statutes. There are numerous federal statutes to which corporations are subject, and the federal courts have addressed successor liability issues in a number of different settings. The most important issues in most asset acquisitions generally involve federal labor statutes and environmental statutes. Judicial interpretations of successor liability issues under these statutes have been strongly influenced by the federal policies underlying those statutes, and the cases generally reflect a strong bias toward imposing obligations on buyers.

   The Supreme Court's decision in *Fall River Dyeing & Finishing v. NLRB*, 482 U.S. 27 (1987) provides perhaps the best example of how different the approach of federal courts can be when it comes to successor liability under federal statutes. In *Fall River*, the Supreme Court held that a newly organized textile manufacturer that did not buy its predecessor's business, and did not even use the predecessor's name nevertheless could be regarded as having a duty to bargain with the union that represented the workers at the old company. Common law doctrines were virtually irrelevant to the court's decision, but the policies behind the federal labor statutes were front and center in its analysis.

   Cases interpreting environmental laws have adopted a broad approach to successor liability. For example, in *North Shore Gas v. Salmon*, 152 F.3d 642 (7th Cir. 1998), the Seventh Circuit imposed CERCLA operator liability on the buyer of a defunct company that operated a mining business that dumped waste at a Superfund site, even though the buyer did not purchase that business and expressly disclaimed any environmental liabilities. Interestingly, and in contrast to the *Fall River* court's approach, the *North Shore Gas* court reached its result by purportedly applying the common law doctrines of "de facto merger" (even though the buyer did not purchase the business) and "mere continuation" (even though the businesses were not identical and the buyer paid a fair price for the acquisition).

   This "warping" of common law doctrines is something that frequently happens in cases interpreting successor liability under federal law. In light of the Supreme Court's holding in *United States v. Kimball Foods*, 440 US 715 (1979), which limited the ability of federal courts to make federal common law even when interpreting federal statutes, the trend in the circuit courts is to move away from a federal common law standard in environmental cases. Nevertheless, as cases like *North Shore Gas* illustrate, it is sometimes striking how different the approach of the federal court is when it borrows state common law doctrines to apply to issues of successor liability under federal law.

   The lesson for purchasers is that they should be very careful in making assumptions about being able to avoid successor liability for obligations under federal statutes. In an area where judicial decisions seem to be so heavily influenced by policy considerations underlying federal statutes, even if a court purports to apply state common law doctrines in resolving successor liability issues, the outcome may be difficult to predict.

   As should be apparent by now, successor liability is not something that can be avoided in all instances, but if buyers and their advisors keep these four points in mind as they structure their due diligence investigation of a seller and in the valuation and negotiating process, they will be in a position to significantly reduce the risks that unexpected responsibility for a seller's liabilities will deprive them of the benefit of their bargain.

Some Thoughts on Appraisal Under Delaware Law

By John F. Grossbauer and Arthur L. Dent, Partners of Potter Anderson & Corroon LLP

Here are some recent practice pointers regarding appraisal rights:

1. **Often Somewhat Overlooked, Appraisal's Relevance May Be Viewed As On The Upswing**

   Appraisal has long been a somewhat overlooked area of Delaware law. Not particularly favored by either the Delaware courts or the legislature, by statute the remedy is provided only in acquisitions by merger. Even then, in mergers involving public companies, the appraisal remedy is not available in stock deals. This last point is important, as an increase in the number of cash deals involving LBOs, in which appraisal rights are available, could result in a greater number of appraisal proceedings being filed.

   Although the appraisal statute, 8 *Del. C.* § 262, requires that the holder of record submit a demand for appraisal in connection with shares for which appraisal is sought, when stock is held in street name—for example, by Cede & Co. as the nominee for the Depository Trust Company—there no longer is any doubt that a beneficial owner need not have held its interest as of the record date set for approval of the merger in order to qualify for appraisal.

   In *In re Appraisal of Transkaryotic Therapies, Inc.*, Consol. C.A. No. 1554-CC (Del. Ch. May 2, 2007), the Delaware Court of Chancery ruled that, for purposes of perfecting appraisal rights, a beneficial owner of stock held of record by a nominee that acquires its beneficial ownership interest after the record date set in connection with the stockholder meeting called to vote on the adoption of the merger need not establish whether and how a prior beneficial owner may have voted the shares. The Court thus clarified that, under the Statute, the focus is on the "holder of record," and that it is the record holder's actions alone that determine perfection of the right to appraisal.

   Although some observers have expressed the view—indeed respondent so argued in *TKT*—that the decision could trigger an increase in the number of appraisal actions filed by hedge funds and other professional investors, which often purchase shares following the announcement of a deal, the practicalities of the appraisal process suggest that concern may be exaggerated. Appraisal litigation is not inexpensive, with the actions typically involving "battles of experts" applying sophisticated valuation models. "Fee shifting" is not provided for under the Statute, and each side thus must bear its own counsel and expert witness fees. Moreover, appraisal proceedings are not expedited, typically playing out over several years. And, while interest awards are authorized under the Statute, interest is seldom awarded at rates approaching the "hurdle" rates demanded by investment funds. Meanwhile, during the pendency of the proceeding the funds ultimately payable to the dissenters are held by the merged company.

2. **Where Appraisal Is Available, Any "Appraisal Out" Should Be Carefully Considered**

   It is not uncommon for acquirors to provide for an "appraisal out," allowing for termination of a merger agreement in the event appraisal is demanded by a certain percentage of the stockholders (for example, 15 percent). Of course, such provisions generally may be waived by the acquiror. In fact, that is what happened in *TKT,* involving a 15 percent threshold. There, holders of record of approximately 35 percent of the stock demanded appraisal. The acquiror, Shire Pharmaceuticals Plc., nevertheless waived the provision and closed on the deal.

   In our view, setting a low triggering threshold could actually encourage shareholders to seek appraisal, or at least to submit appraisal demands in order to pressure the acquiror to increase the deal price. Under the Statute, shareholders may pursue such a course with little risk, as appraisal demands may be withdrawn for a period following the approval of a deal and the shareholders receiving the merger consideration. Thus, serious consideration should be given before determining whether to include such a provision, and, where included, should be set at an appropriate triggering threshold.

3. **Consider Recent Amendments to the Delaware Appraisal Statute**

   In late June, the Delaware Legislature approved several amendments to the Statute, effective as to transactions consummated pursuant to merger agreements entered into after August 1, 2007 (or, in the case of short-term mergers pursuant to Section 253, to resolutions of the board adopted after August 1st), and as to appraisal proceedings arising out of such transactions. One such amendment, to Section 262(e), now authorizes the filing by a beneficial owner of an appraisal petition with the Court. Although the appraisal demand must still be made "by or on behalf of the holder of record," a beneficial owner may now file the appraisal petition with the Court in its own name. Thus, for example, where shares are held in street name and the nominee (typically Cede) has submitted an appraisal demand, the beneficial owner no longer need include the nominee in the caption of the action or involve the nominee in the filing of the appraisal petition.

Section 262(e) has been further amended to permit a dissenting shareholder to withdraw its appraisal demand within 60 days after the effective date of the merger and receive the merger consideration even if, in the interim, another dissenter has filed an appraisal petition with the Court. Formerly, if even a single dissenter filed a petition within the first 60 days following a merger, other dissenters could withdraw their demands for appraisal and receive the merger consideration during the remainder of this 60-day period only by obtaining leave of Court.

One significant amendment involves the awarding of interest. Section 262(h) has been amended to create a presumption that interest will be awarded for the period from the effective date of the merger until the date of payment of the appraisal judgment, compounded quarterly and accruing at the Delaware "legal rate," or 5 percent over the Federal Reserve discount rate as that rate may fluctuate during the period. The Court has the discretion to depart from this approach, however, for "good cause." Formerly, the Court's practice was to award interest at the "prudent investor rate," a rate determined by the Court based on testimony of the parties' experts at trial. Only where the Court concluded that the trial record lacked sufficient evidence from which to derive an appropriate rate would the Court apply, as a default, the legal rate. Depending on the company and the particular investors demanding appraisal, an award of interest at the legal rate may encourage or discourage appraisal actions. Thus, investors' hurdle rates and the company's cost of borrowing are significant factors in determining how a company responds to appraisal demands. Finally, the Statute has been amended to "clarify" that appraisal proceedings are adversarial proceedings, and thus are to be litigated in accordance with generally applicable rules of the Court of Chancery.

As a reminder, the amendments will require practitioners to update their standard appraisal disclosure language and double check proxy statements for merger agreements executed after August 1st to make sure the latest version of Section 262 is attached to the proxy statement.

The SEC Staff's Comment Letters: Termination and Change-in-Control Arrangements

By Dave Lynn, Editor of TheCorporateCounsel.net and former Chief Counsel of the SEC's Division of Corporation Finance

A few weeks ago, the SEC Staff began sending the first wave of comment letters on the executive compensation and related party disclosures in 2007 proxy statements, as part of Phase One of its compensation disclosure review project. Phase Two involves a Staff Report that summarizes what the Staff has seen overall—and more importantly—what the Staff expects for the 2008 proxy season; this Report is expected to be issued later this Fall. One particular area of Staff focus in the comment letters is disclosure about termination and change-in-control arrangements.

The Focus on Change-in-Control and Termination Arrangements in the CD&A

In many of the comment letters, the Staff is requesting a more thorough discussion and analysis of termination and change-in-control arrangements under Reg. S-K Item 402(b), the "Compensation, Discussion & Analysis" section. In particular, the Staff is looking for discussion and analysis of how the actual post-termination awards and benefits are determined, why the issuer has chosen to pay multiples of compensation components as severance or change-in-control payments and why vesting of equity awards is accelerated. In addition, the Staff requests additional disclosure about how these arrangements fit into the issuer's overall compensation objectives and affect decisions made as to other compensation elements, and the rationale for decisions made in connection with these arrangements.

In some circumstances, the Staff asks whether the terms of change-in-control agreements are based on negotiations or through an evaluation of benefits paid by peer companies. Finally, the Staff expects significant differences in the terms of these agreements among the NEO group to be addressed in the CD&A. It is clear from the nature and frequency of these comments that the Staff is seeking significantly more discussion and analysis regarding these arrangements.

Lots of Changes Sought in the Change-of-Control/Termination Section

In addition to the enhanced CD&A disclosure concerning termination change-in-control arrangements, the Staff focuses on compliance with the narrative disclosure requirement in Item 402(j). The Staff's comments are directed at improving the overall presentation of termination and change-in-control arrangements, and in particular, the all important reasons behind these arrangements.

- Tables—While Item 402(j) provides issuers with some flexibility in determining how best to present this disclosure, the Staff indicates a strong preference for a tabular presentation in its comments. It appears that the Staff will push issuers toward tables in an effort to streamline this disclosure and perhaps make it more understandable.
- Terminology—The Staff requests definitions (in plain English) for terms such as "cause," "good reason," "change-in-control" and other similar terms included in these types of arrangements.
- Triggers—In some cases, the Staff asks for an explanation of the specific circumstances that would trigger termination and change-in-control payments.
- Amounts Payable—The Staff requests quantitative information for all amounts payable under termination and change-in-control agreements under all triggering events, along with discussion and analysis of how the actual post-termination benefits and awards were determined – including why various multiples to particular elements of compensation were chosen.
- Totals—While the rules do not require a total that sums up the elements of post-employment compensation for each triggering event, it is clear that under the "principles matter" approach the Staff expects issuers to follow, a totaling up of the numbers is necessary – instead of making shareholders hunt and try to piece together the puzzle. This approach is reflected in the Staff's comments requesting totals. In most situations, we think that such totals will give shareholders a better idea of the real "walk away" value of the issuer's termination and change-in-control agreements.

Going Forward

Given the Staff's focus on the adequacy of the termination and change-in-control arrangement disclosure, companies (including their compensation committees) need to be mindful of how these arrangements will be described in the proxy statement—as well as the disclosure that will be required if the provisions are ultimately triggered.

In light of the new disclosure requirements, some companies have been reevaluating, and in some cases, revising their executive compensation disclosure arrangements. It is very possible that over time, the enhanced disclosure (as reinforced by the Staff's comments) will lead to simpler arrangements with fewer triggering events and reduced payout amounts.