- *Reverse termination fees provide a reliable alternative to innovation.* Parties to a merger may be more comfortable relying on a reverse termination fee as an alternative to innovating other remedy terms such as specific performance or MAE clauses. A seller may use the desirability of the reverse termination fee as a bargaining chip in securing a higher fee amount. In such a negotiation, deal counsel should shift their focus from the fiduciary considerations that restrict forward termination fees to a liquidated-damages analysis.[49] This should prevent subsequent invalidation of the fee as a penalty, mitigate the seller's losses in the event of failure, and provide the buyer with a reliable exit strategy.

- *Interplay of conflicting remedy provisions.* Deal lawyers should take care to draft remedy provisions that have a clear relationship or hierarchy. Counsel should take advantage of the courts' willingness to enforce remedy provisions by using clear language. If counsel plainly set forth how each remedy functions (and interacts with other terms), the parties can rely on the agreement when deciding whether to run with—or away from—a deal.

- *Post-deal behavior matters.* Buyers should be aware that courts may not let them out of their deals scot-free if their behavior is later determined to have been inequitable. Counsel should keep this in mind when advising a buyer on whether it should take a questionable stance based on ambiguous deal terms in an effort to instigate a renegotiation. Counsel should also be careful to consider the difficulties involved when drafting a conditional damages cap. To avoid Hexion's fate, drafters should ensure that the condition and its interaction with other terms are clear to the parties, both during the deal negotiations and as memorialized in the final deal documents.

The courts have demonstrated their commitment to enforcing a broad scope of contractual remedy provisions. This emerging case law should give counsel the confidence and latitude to draft innovative contractual remedies to deal with current market conditions.

Private-equity investors may be quiet now, but they will return when credit begins to flow again. Upon private equity's return, it should meet a new generation of MAE clauses, specific performance terms, and separately negotiated reverse termination fees. In light of the cases we have discussed in this series and with the experience of the credit meltdown in the background, deal counsel should reexamine their reliance on outmoded remedy provisions. This downturn provides an opportunity to create remedy provisions more likely to achieve both buyers' and sellers' legitimate expectations, and thereby more likely to promote deal certainty.

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[49] *See supra* note 38; *see also* Varallo & Rohrbacher, *Reverse Termination Fees*, *supra* note 3, at 10.

Poison in a Pen: Recent Trends in Drafting Shareholder Rights Plans

By Kevin Douglas and Stephen Hinton of Bass, Berry & Sims PLC[1]

In recent months, shareholder rights plans, or poison pills, have been the subject of heightened publicity within the corporate law community as the result of increased poison pill activity during 2008[2] and the first-ever intentional triggering of a flip-in plan in the United States in December 2008.[3] This article analyzes recent trends in drafting shareholder rights plans, based in part upon the authors' review of first-time shareholder rights plans adopted in 2001 and 2008.[4]

As background, poison pills were originally developed by Martin Lipton in the early 1980s, and soon became an integral component of the takeover defenses available to U.S. public companies. Moreover, unlike certain other defensive measures such as classified boards, rights plans can generally be adopted by a company's board of directors without shareholder approval within a short period of time after a threat arises.

The year 2001 was chosen as a point of comparison for purposes of considering drafting trends in this article because it was prior to the dawn of the current era of shareholder activism and heightened focus on corporate governance "best practices" that arose following the enactment of the Sarbanes-Oxley Act of 2002 and the corporate scandals that prompted the passage of the Act. At this time, shareholder activism was significantly less pronounced than today, and proxy advisory services such as Institutional Shareholder Services (now RiskMetrics Group), while in existence, did not enjoy the prominence or influence that they do today. In this environment, the adoption or retention of defensive measures such as a shareholder rights plan did not generally subject companies to the same level of shareholder scrutiny that such an action would today.

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[1] Kevin Douglas is a member, and Stephen Hinton is an associate, at Bass, Berry & Sims PLC. The views expressed in this article are those of the authors and do not necessarily represent the views of Bass, Berry & Sims or its clients.

[2] In a year marked by a sharp decline in U.S. market capitalization and increased hostile and unsolicited takeover activity, the total number of first-time U.S. pill adoptions increased to 76 in 2008 from 42 in 2007, the first year-over-year increase since 2004-2005.

[3] In late December 2008, a shareholder of Selectica, Inc. filed a Schedule 13D/A announcing that such shareholder had "purportedly" become an acquiring person under Selectica's rights plan (Selectica's board of directors had previously lowered the flip-in ownership trigger under its rights plan from 15% to 4.99% in November 2008 for the purpose of preserving the company's net operating loss carryforwards and tax credits). After the pill had been triggered, Selectica's board of directors exercised the exchange feature under the rights plan, exchanging one share of common stock for each outstanding right (other than rights held by the acquiring person) under the rights plan, and then declared a dividend of preferred share purchase rights under the plan to replace the exchanged rights. Selectica also filed a complaint with the Delaware Chancery Court seeking a declaratory judgment that the rights plan was valid, which litigation was ongoing as of the date of the submission of this article.

[4] Data available on FactSet SharkRepellent.net was invaluable in providing background information used in writing this article.

plan being submitted to shareholders for their approval, RiskMetrics advocates that plans include certain other features.[5]

The trend to terminate rights plans and to otherwise dismantle takeover defenses has been particularly strong among large-cap companies, which generally have been subject to a higher level of scrutiny from corporate governance watchdogs and shareholder activists. Approximately [illegible] of Fortune 500 companies had a shareholder rights plan in effect at the end of 2001,[6] compared to less than [illegible] today.[7] Overall, less than 1,000 U.S. public companies have shareholder rights plans in effect today,[8] compared to over 2,000 U.S. public companies in 2001.[9]

As the total number of companies with shareholder rights plans has decreased, there has been a significant increase in the number of plans that are "in-play" adoptions (adopted in response to a specific takeover threat). In 2008, 22% of all first-time adoptions were in-play adoptions (as defined by FactSet SharkRepellent.net[10]), compared to 2% in 2001.[11]

Analysis—and Practice Pointers—of Recent Drafting Trends

Based on a review of 2008 plans and 2001 plans that were first-time adoptions,[12] it is apparent that the increased influence of shareholder activists and proxy advisory services has not only resulted in a decrease in the number of U.S. public companies with shareholder rights plans in place, but has also resulted in a higher proportion of plans being adopted that have various "shareholder-friendly" provisions. In particular, the following trends emerge:

1. Term of Plan—First-time shareholder rights plans adopted in 2008 are significantly more likely to have a shorter term than first-time plans adopted in 2001. [illegible] of 2008 first-time adoptions had a term of ten years, compared to [illegible] of surveyed 2001 first-time adoptions. In addition, [illegible] of 2008 first-time plans had a term of three years or less, compared to none of the surveyed 2001 first-time adoptions. The increased percentage of shorter-term plans has resulted in part from the fact that in-play adoptions (which are now more common) are more likely to have a shorter term.[13] However, even setting this factor aside, 2008 plans that were not in-play adoptions were also significantly more likely to have a shorter term compared to their 2001 counterparts,[14] reflecting the view of activist shareholders and corporate governance watchdogs that longer terms are undesirable.

2. Shareholder Approval—Despite the strong preference of shareholder activists for companies to submit shareholder rights plans to shareholders for approval, and the fact that RiskMetrics will recommend a

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[5] In making a determination whether to approve a plan submitted to shareholders for their approval, RiskMetrics recommends that plans include the following features:

- (i) minimum 20% trigger for flip-in or flip-over;
- (ii) a maximum term of three years;
- (iii) no features that limit the ability of a future board to redeem rights under the plan; and
- (iv) a shareholder redemption clause that permits holders of at least 10% of the shares to call a special meeting or seek a written consent to rescind the plan if the board refuses to redeem the rights under the plan within 90 days after an offer is announced.

RiskMetrics sets forth separate criteria in connection with pills adopted for the purposes of preserving a company's net operating losses ("Section 382 rights plans").

[6] Mark Saltzburg, Riskmetrics Group's Risk and Governance Blog, March 23, 2006, available at http://blog.riskmetrics.com/2006/03/poison_pills-issues_in_2006_and.html.

[7] According to data from FactSet SharkRepellent.net.

[8] According to data from FactSet SharkRepellent.net.

[9] John Laide, *Shareholder Input on Poison Pills*, April 23, 2007, available at https://www.sharkrepellent.net/pub/rs_20070424.html.

[10] FactSet SharkRepellent.net defines an "in-play" adoption to include plans adopted (i) to thwart an unsolicited or hostile takeover offer, (ii) to safeguard a friendly merger by preventing any third party from launching a challenging offer, (iii) as a result of disclosure of a significant stake purchase or (iv) in connection with a company's plans to explore strategic alternatives, including a sale of the company.

[11] According to data from FactSet SharkRepellent.net.

[12] For purposes of this survey, except where noted below, the authors reviewed all first-time shareholder rights plans adopted in 2008, as well as 100 randomly-selected first-time shareholder rights plans adopted in 2001 (according to data from FactSet SharkRepellent.net, there were a total of 258 first-time adoptions in 2001). Although Section 382 rights plans are discussed below, the authors have not (except where noted) included Section 382 rights plans in the general survey data as the result of the fact that there are different considerations involved in drafting such plans, related in part to the significantly lower ownership triggering threshold (typically, 4.9% or 4.99%) under such plans.

[13] Ten out of sixteen 2008 in-play first-time adoptions had a term of three years or less, while six had a term of ten years (two of which plans will expire in one year if not approved by shareholders).

[14] Of 2008 plans that were not in-play adoptions, 41% had a term of three years or less, while 55% had a term of ten years.

withhold vote for all directors (other than new nominees) who adopt a plan and do not submit the plan for shareholder approval within 12 months, the vast majority of companies that adopted poison pills in 2008 have not submitted (or committed to submit) their plans to shareholders for approval, although this practice is more common than it once was.[15]

Companies should be aware that voluntarily submitting a plan for shareholder approval may run counter to the intended purpose of a plan to deter coercive actions by one or more significant shareholders (who may oppose a plan if voted upon) and be mindful of the risks in following this approach.

3. Triggering Ownership Threshold—[illegible]

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4. Derivatives—A significant number of companies included derivatives in the ownership definition in plans for the first time in 2008 in response to the increasing (and more publicized) use of these instruments by hedge funds and other activist shareholders (a total of 20 first-time plans adopted in 2008 included derivatives in the ownership definition).[16]

An advantage of including derivatives in the ownership definition is that this approach will restrict the abusive use of derivatives by shareholders, including shareholders who seek to avoid disclosing their positions based on the current lack of a clear SEC requirement for 5% shareholders to disclose derivative positions on Schedule 13D, such as occurred in the emblematic case of *CSX Corporation vs. The Children's Investment Fund Management (UK) LLP, et al.*[17] However, companies considering this feature will also want to be mindful of the risk of an inadvertent trigger[18] and the fact that the validity of this feature has not yet been tested under Delaware law.

5. Discount Upon Flip-In Event—[illegible]

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[15] 13% of first-time plans that were adopted in 2008 were submitted to shareholders for their approval or included a provision that provided for the plans' termination if they were not approved by shareholders within one year of adoption. In contrast, none of the surveyed 2001 first-time plans were submitted to shareholders for their approval or included such a shareholder adoption provision.

[16] In addition, as 2008 progressed, an increasing percentage of companies included derivatives within their ownership definition in plans: 42% of companies adopting first-time plans during the last three months of 2008 included derivatives within their ownership definition, compared to 16% of companies adopting first-time plans during the first nine months of 2008.

[17] 562 F. Supp. 2d 511 (S.D.N.Y. 2008). In *CSX,* a hedge fund entered into cash-settled total return swaps with eight counterparties covering over 14% of CSX's shares but did not file a Schedule 13D since the shareholder's beneficial ownership remained just under 5%. Moreover, as is common in such arrangements, the counterparties to such swaps hedged their position by purchasing the shares underlying the swaps. In *CSX*, the court held that the tactics of the fund violated the anti-evasion provision of SEC Rule 13d-3(b), but that it did not have the authority to interfere with the voting power of the hedge fund's or its counterparties' shares. The court noted that even though such derivative positions may not involve the activist investor gaining voting power over the referenced shares, such positions at a minimum alter the makeup of the shareholder base and also present incentive for a counterparty to vote its shares in favor of the activist investor's interests to keep and/or attract business.

[18] This risk can be minimized by inadvertent trigger language in a plan that allows a shareholder to divest of its ownership if a shareholder has accidentally triggered the pill.

[19] All first-time plans adopted in 2008 and all but one surveyed 2001 first-time plans provided for a 50% discount.

[20] *See, e.g.*, William Lawlor, Ian Hartman and Eric Siegel, *Time to Install a Pill? Dealing with Rights Plans in a Down Market*, Deal Lawyers (January-February 2009), at 3 ("There is nothing inviolate or talismanic about a certain flip-in ownership threshold, 50% market discount or 3-5x market multiple.").

6. Class of Stock Issuable Upon Flip-In Event—The absence of blank-check preferred authority in a company's charter, or the lack of a sufficient number of authorized preferred or common shares, may preclude the adoption of an effective shareholder rights plan by not allowing for the massive dilution that is intended to occur upon the triggering of a plan.

In practice, most plans are adopted by companies that have blank check preferred or otherwise have authorized preferred stock. [illegible] of first-time 2001 plans provided for the issuance of preferred rather than common stock upon a distribution event, while [illegible] of those plans provided for the issuance of common stock upon a flip-in event to the extent a sufficient amount of common stock was available for issuance.

7. TIDE—14% of first-time plans adopted in 2008 included a Three Year Independent Director Evaluation, or "TIDE" provision, whereby a committee of the board of directors comprised of independent directors meets periodically (typically, every three years) to review whether a plan should be terminated or modified (none of the surveyed 2001 plans included such a provision). The relevance of this provision in the current environment is somewhat lessened by the fact that an increasing number of plans have a term of three years or less.

8. Permitted Offer/Qualified Offer Plans—Permitted offer pills (whereby a flip-in event will not occur under the plan in connection with tender and/or exchange offers that meet predefined criteria, including board approval) remain more prevalent than qualified offer, or "chewable," pills (whereby a flip-in event will not occur under the plan in connection with tender and/or exchange offers that meet predefined criteria, regardless of whether the offer is approved by the board either automatically or by a shareholder vote), although chewable pills have become more common in recent years.[21]

Overall, 20% of surveyed 2008 plans included a permitted offer provision, compared to [illegible] of surveyed 2001 plans, while 8% of surveyed 2008 plans included a qualified offer provision, compared to none of the surveyed 2001 plans. The increase in qualified offer plans stems from the preference of shareholder activists for a third-party offer exemption that can be satisfied without board approval.

Permitted offer provisions typically provide that the plan will not apply to offers for all of the outstanding shares of the company that are deemed by a majority of unaffiliated board members to be fair and/or not inadequate and that are in the best interests of the company and its shareholders. There is more variation among qualified offer provisions regarding what criteria an offer must satisfy to meet this exception, as noted below:

- Among 13 plans adopted (whether or not first-time adoptions) in 2008 with a qualified offer provision or amended to include such a provision ("2008 qualified offer plans"), all required an offer for all of the outstanding shares of the company.
- 85% of the 2008 qualified offer plans required that a minimum percentage of the outstanding shares (or a minimum percentage of the shares not held by the offering person) tender in the offer.
- 70% of the 2008 qualified offer plans required that a minimum premium be paid in the offer (for example, a specified premium over the five days or one-year weighted average stock price of the company prior to the offer).
- 92% of the 2008 qualified offer plans required that the offering person agree to effect a second-step transaction promptly after consummating the offer, and pay the same consideration in this second-step transaction as in the original offer.

9. Exchange Provision—Virtually all of the surveyed 2001 and 2008 plans included an exchange provision, whereby the board is typically given the authority, after a flip-in event has occurred, to exchange one share of common stock of the target for each outstanding right under the plan prior to the time that an acquiring person acquires 50% of the stock of the target. If utilized, this provision will typically decrease, though not eliminate, the amount of dilution that will occur upon the triggering of a plan.

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[21] "Permitted offer" and "qualified offer" terminology is not standard throughout all plans, and some plans may, for example, have a "qualified offer" provision pursuant to which board approval is required.

In addition, this provision increases the board's flexibility upon a flip-in event, and eliminates any uncertainty regarding whether enough shareholders will exercise their rights upon a flip-in event to cause sufficient dilution to the acquiring shareholder. This provision was utilized by the Selectica board in early January 2009 when a shareholder deliberately triggered the company's plan.

10. Dead-Hand, No-Hand, Slow-Hand— [illegible]

[illegible]

A benefit of the deadman's trigger is that such a bright-line approach may help a plan achieve its maximum deterrent effect by ensuring extreme dilution the moment a flip-in event occurs. In contrast, an advantage of providing for a brief window period for redemption is that this feature may increase a board's flexibility and help permit a white knight transaction under these circumstances. In practice, the distinction between these two approaches has been academic in that no flip-in plan in the United States had ever been deliberately triggered, at least until the Selectica example cited above.

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[22] *See Mentor Graphics vs. Quickturn Design Systems, Inc.*, 728 A.2d 25 (Del. Ch. 1998) (invalidating slow hand, and by implication, dead hand, poison pills under Delaware law); *see also Carmody vs. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998). A "dead hand" plan provides that only incumbent directors may amend or redeem the rights plan. A "no hand" plan precludes any board, continuing or new, from amending or redeeming the rights plan. A "slow hand" pill has a delayed redemption feature which prevents a new board from redeeming a plan for a specified period of time, often 180 days.

[23] For purposes of this review, the authors did not include as a deadman's trigger a redemption provision that allowed for redemption until a "distribution event" because such framework under certain circumstances would allow a redemption after the occurrence of a flip-in event.

The Ultimate Takeover Defense?
RiskMetrics' New View on Net Operating Loss Poison Pills

By Dante Deliso of Hogan & Hartson LLP

Tight credit markets and recessionary pressures have historically led to an increase in strategic M&A. Hardly anyone has been immune to the recent devastating effects on equity values and many companies have watched their share price drop more than 50% over the past year. These factors tend to lead companies with cash on hand and driven by the never ending pressure to find new growth and increase shareholder value, to take advantage of the depressed market conditions and acquire competitors or other strategic targets that can not weather the downturn. The current downturn, arguably the worst since the Great Depression, has paved a smooth road for companies in the enviable position of being cash rich to accomplish this goal.

To add to the plight of these distressed companies, many have given in to the overwhelming pressure from activists over past years to dismantle their takeover defenses.[1] Couple this with the drastic drop in share price and these companies are virtually defenseless against an unwanted takeover. This is a scary thought considering unsolicited takeover attempts more than doubled in 2008,[2] a development that is likely to grow exponentially once financing becomes available and companies start shopping the clearance racks.

When confronted with a takeover bid, a board is forced to determine whether the recent decline in the company's stock price is a true reflection of the company's long-term prospects or just a temporary dislocation of valuation. A board, tasked with maximizing shareholder value, will fail at its duty if it allows the company to be taken over at a time when its share price reflects only a fraction of its true value. However, if the proper takeover defenses are not in place—even if a board decides an offer does not reflect the company's true value—it may be powerless to thwart the takeover.

The most effective takeover defense a board can implement is a shareholder rights plan. A shareholder rights plan—also known as a "poison pill"—effectively works as a dividend that once triggered massively dilutes the acquiror's holdings making the acquisition prohibitively expensive. Boards love poison pills because they provide leverage at the bargaining table giving the board a stronger voice in the timing and terms of a takeover. Poison pills also provide time for a company unhappy with its current suitor to locate a more suitable acquiror (a so-called "white knight") or to identify other value enhancing alternatives. Shareholders benefit from poison pills because they have historically resulted in increased takeover premiums without diminishing the overall completion percentage of announced takeover bids.[3]

Pills and the Lack of Investor—and RiskMetrics—Support

While poison pills can provide great benefit to companies and their shareholders, they do not receive widespread support. Some view poison pills as an entrenchment tactic by management and believe that they take power away from the shareholders to consider potentially worthy takeover bids. RiskMetrics Group, the leader in providing proxy analysis and advice to investors maintains a poison pill policy that reflects such concerns. Many institutional investors look to RiskMetrics's voting advisory policies to determine how to vote and a negative recommendation by RiskMetrics can significantly impact the results of a shareholders' meeting.

RiskMetrics' current policy states that they will only consider supporting proposed pills that meet certain guidelines. These guidelines require proposed pills to have a trigger threshold of 20% or higher, contain a three-year sunset provision, not include any features similar to a dead-hand, slow-hand or no-hand feature,[4] be submitted to shareholder vote within twelve months of adoption and have a shareholder

[1] Sharkrepellent.net, *2008 Year End Review*, https://www.sharkrepellent.net/pub/rs_20090122.html.

[2] *Id.*

[3] Georgeson & Company, Inc., *Poison Pills and Shareholder Value 1992-1996*, M&A LAWYER, Sept. 1998.

[4] A "dead-hand" provision restricts the right to amend or redeem the poison pill to the original directors who adopted it. This prevents an unwanted acquirer from ousting a majority of the incumbent directors and having the newly elected directors amend or redeem the pill to allow for the acquisition. A "slow-hand" provision prevents a poison pill from being amended or redeemed for a specified period of time after a change in a majority of directors. A "no-hand" provision prohibits the amendment or redemption of the poison pill by any board.

redemption feature allowing for ten percent of the shares to call a special meeting or seek written consent to vote on rescinding the pill if the board refuses to redeem the pill within 90 days after an offer is announced.[5]

[illegible]

What is a "Net Operating Loss Poison Pill"?

The severe economic downturn is causing a need for stronger takeover defenses and may have opened a door allowing companies that have incurred net operating losses over the past few years to adopt poison pills with trigger thresholds far below RiskMetrics' current policy without receiving a negative recommendation from RiskMetrics. This can be accomplished by adopting a Net Operating Loss Poison Pill or "NOL Pill."

[illegible]

RiskMetrics' Latest NOL Pill Position

RiskMetrics, however, has made it clear in the '09 update to their guidelines that they will consider this rationale for adopting a pill in their analysis by indicating a willingness to support NOL Pills under certain circumstances.[8] RiskMetrics' 2009 policy states that they will consider NOL Pills on a case-by-case basis taking the trigger threshold, the value of the NOLs, the term of the pill, along with other existing shareholder protection mechanisms, into account when making their recommendation.[9]

[illegible]

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[5] RiskMetrics Group, *U.S. Proxy Voting Guidelines Concise Summary*, http://www.riskmetrics.com/sites/default/files/RiskMetrics2009SummaryGuidelinesUnitedStates.pdf.

[6] Sharkrepellent.net, *Unfriendly First Quarter of 2008*, https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20080402.html&rnd=766486.

[7] I.R.C. § 382; RiskMetrics Group, *Net Operating Loss Poison Pills (U.S.) 2009 Draft Policy for Comment*, http://www.riskmetrics.com/policy/2009_nol.

[8] RiskMetrics Group, *Voting Guidelines*, supra note 5.

[9] *Id.*

Delaware Upholds Private Equity Deal Structures

By Steven Haas of Hunton & Williams LLP

On January 15, 2009, Vice Chancellor Leo E. Strine, Jr., of the Delaware Court of Chancery dismissed claims brought by Alliance Data Systems, Inc. ("ADS") against affiliates of the Blackstone Group L.P. ("Blackstone") over a failed merger. The decision, *Alliance Data Systems Corp. v. Blackstone Capital Partners V. L.P.*[1], enforced the plain terms of a merger agreement and refused to impose any obligations on the non-signatory private equity sponsors.

It is an important lesson that, in dealing with private equity firms, target corporations must contractually bind those firms if they need them to take specific actions to consummate the transaction. Otherwise, target corporations must negotiate for reverse termination fees guaranteed by the sponsors or potentially be left without recourse.

Background

On May 17, 2007, ADS entered into a $7.8 billion merger agreement with Aladdin Holdco, Inc., and Aladdin Merger Sub, Inc. (the "Aladdin Entities"). The Aladdin Entities were owned, directly or indirectly, by Blackstone Capital Partners V L.P., a $20 billion private equity fund formed by the Blackstone Group. In typical fashion for private equity portfolio company structures, Aladdin Holdco would be Blackstone's holding company, while Aladdin Merger Sub would be merged with and into ADS. Neither of the Aladdin Entities had any assets, other than debt and equity commitments to fund the merger.[2]

More importantly, no other Blackstone affiliate was a party to the merger agreement. The only contractual commitment between ADS and Blackstone was a "limited" guarantee executed by Blackstone Capital Partners V L.P. to guarantee payment of a "Business Interruption Fee" payable to ADS in the event the Aladdin Entities breached the merger agreement. Consistent with most private equity transactions in recent years, the limited guarantee was ADS's sole recourse against Blackstone in the event of a breach by its acquisition subsidiaries.

The merger agreement required the parties to obtain all necessary governmental approvals as a condition to closing. Because ADS owned a credit card bank called World Financial Network National Bank ("World Financial"), the merger had to be approved by the Office of the Comptroller of the Currency (the "OCC"). From the outset, the OCC took an intractable stance that required Blackstone to backstop World Financial's capital and liquidity. Blackstone balked at the OCC's requests and refused to expose its assets, other than the Aladdin Entities, to potential liability for World Financial's operations.

After several rounds of negotiations and proposed concessions, it became apparent that neither Blackstone nor the OCC would back down from their positions. Accordingly, the merger agreement was terminated on the drop-dead date because the closing condition requiring that all regulatory approvals be obtained was not satisfied. ADS thereafter sued the Aladdin Entities and Blackstone Capital Partners V L.P., claiming the Aladdin Entities breached the merger agreement by failing to cause Blackstone to take the steps necessary to secure the OCC's consent.[3] Pursuant to the terms of the merger agreement, ADS sought damages equal to $170,000,000 in the form of the Business Interruption Fee, which was payable only if the Aladdin Entities breached the contract.

Analysis: Court's Decision Dismissing Breach of Contract Claims

ADS pursued four primary claims as to how the Aladdin Entities had breached the merger agreement. First, ADS alleged that the Aladdin Entities breached their covenant to use "reasonable best efforts" to obtain the OCC's approval. Second, ADS alleged that the Aladdin Entities breached their covenant to prevent Blackstone from doing anything that would impede consummation of the transaction. Third, ADS alleged that the Aladdin Entities breached their representation that they had all necessary power and authority to consummate the merger and perform their obligations under the merger agreement. Finally, ADS claimed that the Aladdin Entities breached the implied covenant of good faith and fair dealing. The

[1] *Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P.*, C.A. No. 3796-VCS, mem. op. (Del. Ch. Jan. 15, 2009).

[2] *See id.* at 8 ("[T]he bottom line is that… Aladdin was an acquisition vehicle with no business or cash of its own, other than assets given to it to enable it to acquire ADS.").

[3] ADS initially sued the Aladdin Entities in January 2008 claiming that they were in breach of the merger agreement by refusing to accede to the OCC's demands. *See id.* at 18–19. ADS withdrew that suit after the Aladdin Entities continued their negotiations with the OCC.

Court rejected each of these arguments, finding that ADS's allegations were inconsistent with the plain meaning of the merger agreement.

The Reasonable Best Efforts Covenant

ADS's first argument was based on the parties' general covenant to use their reasonable best efforts to obtain all necessary government approvals. Specifically, Section 6.5.1 of the merger agreement stated that:

> Each of the Parties shall use its reasonable best efforts to take, or cause to be taken, all actions, and to do, or cause to be done, and to assist and cooperate with the other parties in doing, all things necessary, proper or advisable under applicable Laws to consummate and make effective, in the most expeditious manner practicable, the transactions provided for in this Agreement, including… the taking of such actions as are necessary to obtain any requisite approvals, consents, Orders, exemptions or waivers by, or to avoid an action or proceeding by, any Third Party or Governmental Entity relating to antitrust, merger and acquisition, competition, trade, banking or other regulatory matters.

ADS argued that this covenant was breached because it required the Aladdin Entities to cause Blackstone to obtain OCC approval, including acquiescing to the OCC's demands.

[illegible]

The best efforts covenant was also undercut by other provisions in the merger agreement that specifically addressed Blackstone. In particular, the parties agreed to an antitrust covenant in which the Aladdin Entities agreed to "cause each other member of the Parent Group [defined to include the Blackstone Group and its affiliates] to… offer to commit to take any action which it is capable of taking [to get antitrust approval]."[6] Having reasoned that the parties had clearly delineated the types of conduct for which the Aladdin Entities would be responsible regarding Blackstone's actions, the Court concluded that "as to antitrust approval, but not OCC approval, Aladdin committed itself to being held liable for breach of contract if it could not get Blackstone to do what was necessary to get regulatory approval."[7]

[illegible]

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The Negative Covenant

ADS's next argument alleged that the Aladdin Entities breached a negative covenant set forth in Section 6.5.6 of the merger agreement that required them to prevent Blackstone from taking any action that might inhibit the merger. That covenant provided that:

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[4] *Id.* at 26.

[5] *Id.* (emphasis added).

[6] *Id.* at 27 (second alteration in original).

[7] *Id.*

[8] *Id.* at 31.

[9] *Id.* at 29 n.60.

> Except as expressly contemplated by this Agreement, neither [Aladdin Holdco] nor [Aladdin] Merger Sub shall, and each ... shall cause each member of the [Blackstone parent group] not to, take or cause or permit to be taken any action (including the acquisition of businesses or assets) which would reasonably be expected to prevent or materially impair or delay the consummation of the transactions contemplated by this Agreement.

The Court rejected ADS's proffered interpretation of the provision and explained that Section 6.5.6 "is plainly limited to keeping Blackstone from acting in an *affirmative way* to prevent, impair, or delay the closing of the Merger."[10] Since the crux of ADS's argument was Blackstone did not take the actions requested by the OCC, it followed that ADS was not challenging any "affirmative step" by Blackstone. Thus, the Aladdin Entities could not have breached their contractual obligation. "Because liability under a negative covenant can only arise from an action," the Court stated, "Blackstone's refusal to consent to the OCC Proposal is not a violation of a negative covenant."[11]

The Representation Relating to Power and Authority

In addition to its focus on the Aladdin Entities' covenants, ADS claimed that the Aladdin Entities breached a representation that they had the necessary power and authority to perform their obligations under the merger agreement and consummate the merger. In the merger agreement, each Aladdin Entity made a standard representation and warranty that it had "all necessary corporate power and authority to execute and deliver th[e] Agreement, to perform its obligations… and to consummate the transactions…." ADS reasoned that this representation was breached if the Aladdin Entities did not have the power or ability to control Blackstone in order to obtain all necessary governmental approvals.

The Court characterized this argument as a "strained" one and said it "distort[ed] the plain meaning of a common term in acquisition agreements."[12] The Court explained that the representation only established the basic power and authority of the signatories making the representation—and that it was not an assurance that those signatories "had unfettered control to make Blackstone and all of its affiliates do whatever Aladdin wished."[13]

Notably, the Court was not persuaded by ADS's claims that the Aladdin Entities and Blackstone were controlled by the same person: Blackstone's CEO Stephen Schwarzman. The Court stated that:

> the issue is not one of Blackstone's or Schwarzman's power; it is whether Blackstone or Schwarzman had any contractual duty to ADS, and the answer is clearly that they did not. Likewise, the issue is not whether Schwarzman had sufficient managerial power to cause Blackstone to act at the OCC's behest; the question is whether Aladdin had any duty to cause Blackstone to act to meet the OCC's demand.... The answer to this question is also clear: Aladdin did not.[14]

The Court concluded by reiterating that the Aladdin Entities were responsible for Blackstone's actions only pursuant to specific provisions in the merger agreement, such as the covenant to obtain antitrust approval, where they expressly agreed to do so.

The Implied Covenant of Good Faith and Fair Dealing

Finally, ADS made a generalized argument that the Aladdin Entities breached the implied covenant of good faith and fair dealing inherent in all contracts. It appears that, in making this argument, ADS alleged that the parties knew when they negotiated the merger agreement that they would need OCC approval and that Blackstone might have to take actions to help secure that approval. This argument backfired since it suggested ADS should have secured a contractual commitment to secure Blackstone's cooperation with the OCC.

But, in any event, the Court followed a line of Delaware cases refusing to impose the implied covenant on issues specifically addressed in contracts between sophisticated parties. It explained that "[t]o imply such an obligation [to cause Blackstone to secure the OCC approval] on Aladdin's part would not vindicate an expectation clearly signaled by the express terms of the Merger Agreement itself. It would impose

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[10] *Id.* at 33 (emphasis added).

[11] *Id.* at 34.

[12] *Id.* at 37.

[13] *Id.* at 36.

[14] *Id.* at 39.

an after-the-fact obligation on Aladdin that ADS was unable to obtain in the contractual negotiations and contradict the plain terms of the Merger Agreement."[15]

The Bottom Line

The *ADS* decision is a validation of the private equity model of M&A deals. The Court enforced the plain terms of a contract that shielded a private equity sponsor from contractual liability for the actions of its wholly-owned shell subsidiaries. Private equity firms aggregate capital and invest them in a variety of portfolio companies. The nature of this model requires private equity firms to carefully manage parent-level risk exposure.

But on a more abstract level, the *ADS* decision is a victory for the corporate form in mergers and acquisitions. As Vice Chancellor Strine explained:

> A huge amount of wealth generation results from the use of distinct entities by corporate parents to conduct business. This allows parents to engage in risky endeavors precisely because the parents can cabin the amount of risk they are undertaking by using distinct entities to carry out certain activities. Delaware law respects corporate formalities, absent a basis for veil piercing, recognizing that the wealth-generating potential of corporate and other limited liabilities entities would be stymied if it did otherwise.[16]

Thus, strategic buyers that employ operating companies or other acquisition subsidiaries to do deals can take similar comfort in the Court's decision.

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ADS also warrants a special note about fulfilling "best efforts" covenants. Based on the allegations in the complaint, it appears the Aladdin Entities undertook various efforts to appease the OCC, including a proposal to pledge $400 million of liquid securities to guarantee World Financial's minimum capital and liquidity requirements. Mainly due to those actions, ADS was unable to claim that the Aladdin Entities failed their own contractual duty to use best efforts—a claim that would have entitled ADS to the Business Interruption Fee. This situation stands in sharp contrast to the September 2008 decision in *Hexion Specialty Chemicals v. Huntsman Corp.*, where the record at trial showed a private equity buyer taking significant steps to avoid a transaction in breach of its general covenant to use best efforts to close the transaction.[18] Assuming *arguendo* that Blackstone was trying to abandon the ADS deal due to adverse market conditions, its transactional lawyers seem to have sufficiently documented the steps taken by its acquisition subsidiaries to protect them from a breach of contract claim.

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[15] *Id.* at 42.

[16] *Id.* at 39.

[17] *See, e.g.*, American Bar Association, Committee on Negotiated Acquisitions, Model Stock Purchase Agreement § 6.1 (1995) ("Buyer will, and will cause each Related Person to, … cooperate with Sellers in obtaining all consents….").

[18] *See Hexion Specialty Chem., Inc. v. Huntsman Corp.*, 2008 WL 4409466 (Del. Ch. Sept. 29, 2008).

Recent Developments under the Delaware Short-Form Merger Statute

By Robert Reder, John Timmermann and Matthew Thiel of Milbank, Tweed, Hadley & McCloy LLP[1]

Delaware, like most jurisdictions, provides a streamlined procedure for a corporate shareholder owning a substantial majority of the shares of a subsidiary corporation to "squeeze out" the minority shareholders by forcing them to take cash (or other consideration) in exchange for their shares. Under Section 253 of Delaware's General Corporation Law (the "*Short-Form Merger Statute*"), a corporation owning at least 90% of the outstanding shares of *each* class of stock of another corporation entitled to vote on a merger may merge that corporation into itself (or merge itself into that corporation) *without* seeking the approval of either the board of directors or the minority shareholders of the subsidiary corporation.

However, the Short-Form Merger Statute does provide that, rather than accept the consideration provided in the short-form merger, a minority shareholder may seek an appraisal of the fair value of his or her shares under Section 262 of Delaware's General Corporation Law (the "*Appraisal Statute*"). The Appraisal Statute contains detailed, and time-sensitive, notification procedures for any minority shareholder who desires to challenge the valuation offered in the short-form merger.

The distinction between short-form mergers and long-form mergers was made particularly significant by the ruling of the Delaware Supreme Court in *Glassman v. Unocal Exploration Corp*. ("*Glassman*")[2] that, "absent fraud or illegality, appraisal is the exclusive remedy available to a minority stockholder who objects to a short-form merger." By contrast, a long-form merger between a parent corporation and a less-than-90% subsidiary corporation will, in the words of the Delaware Court of Chancery (the "*Chancery Court*"), "implicate issues of fiduciary duty, and a parent company and its directors will be liable to minority shareholders unless they can demonstrate the entire fairness of the transaction, including fair price and fair dealing." [3] Hence, as a strategic matter, it makes sense for a minority shareholder "squeezed out" in a short-form merger to press a claim that the Short-Form Merger Statute is not, for technical reasons, applicable to the merger. By the same token, it is advantageous for a controlling shareholder to establish that a minority shareholder has not strictly complied with the terms of the Appraisal Statute, thereby forfeiting the only avenue available for attacking a short-form merger.

Although the factual underpinnings of the transactions in which the Short-Form Merger Statute is employed are relatively straightforward, courts frequently have been called upon to adjudicate disputes over the interpretation and/or application of the Short-Form Merger Statute. The purpose of this article is to discuss three recent decisions in which courts have resisted attempts by minority shareholders to avoid the applicability of the Short-Form Merger Statute and upheld the primacy of the Appraisal Statute as the exclusive remedy for minority shareholders who wish to attack the transaction provided in a short-form merger.

1. *Matulich*

In *Matulich v. Aegis Communications Group, Inc.* ("*Matulich*"),[4] the Chancery Court sustained the applicability of the Short-Form Merger Statute to a parent/subsidiary merger even though the parent corporation did not own 90% of a series of subsidiary corporation preferred stock that, by its terms, had a consent right with respect to mergers to which the subsidiary was a party. In so ruling, the Chancery Court drew a distinction between the contractual rights of holders of a series of preferred stock to participate in the *exercise of consent rights* with respect to a merger and the statutory *right to vote* on the merger itself for purposes of the Short-Form Merger Statute.

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[2] *Glassman v. Unocal Exploration Corp.,* 777 A.2d 242 (Del. 2002).

[3] *See Matulich v. Aegis Communications Group, Inc.* 2007 WL 1662667 (Del. Ch., May 31, 2007), *aff'd*, 942 A.2d 596 (Del. 2008).

[4] 2007 WL 1662667 (Del. Ch., May 31, 2007), *aff'd*, 942 A.2d 596 (Del. 2008).

Background and Claims

On November 3, 2006, Essar Services (Mauritius) (f/k/a World Focus) ("*World Focus*"), a Mauritius company which then held over 94% of the common stock of Aegis Communications Group, Inc., a Delaware corporation ("*Aegis*"), purported to squeeze out the minority shareholders of Aegis pursuant to a merger effected under the Short-Form Merger Statute. Under the terms of the merger, Aegis' minority shareholders were required to accept $0.05 in cash in exchange for each of their shares.

[illegible]

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Unhappy with the payment he was required to accept in the merger, Carlo Matulich, who, *notably*, was a minority holder of *common* stock of Aegis but did not own any shares of Series B Preferred, brought suit seeking to have the Short-Form Merger Statute declared inapplicable to the merger. According to Mr. Matulich, World Focus, the parent corporation, did not own "at least 90% of the outstanding shares of each class of the stock" of Aegis, the subsidiary corporation, "entitled to vote on such merger." As a result, Mr. Matulich claimed, the merger, while effective under the provisions of the General Corporation Law governing long-form mergers, was not a merger to which the Short-Form Merger Statute was applicable. Mr. Matulich sought to take advantage of this distinction so that he could bring breach of fiduciary duty claims and seek monetary damages, rather than seeing his remedies limited to a valuation of his shares under the Appraisal Statute.

Consent Rights versus Voting Rights

The Chancery Court addressed the issue as both one of contractual interpretation (of the Series B Preferred certificate of designations) and statutory interpretation (of the Short-Form Merger Statute). Mr. Matulich argued that the Series B Preferred's consent right constituted a right to vote on the merger, notwithstanding the arguably contradictory provision of the certificate of designations stating that the Series B Preferred had "no voting rights." The defendants countered that the right of the Series B Preferred to consent to a merger was not akin to the statutory right of a shareholder to vote his or her shares on a particular matter, but rather more in the nature of "a lender's consent right."

[illegible]

As such, according to the Chancery Court, Aegis had created a series of its preferred stock "that could consent to a merger without possessing voting rights for purposes of" the Short-Form Merger Statute. The fact that World Focus did not own 90% of the Series B Preferred was, therefore, meaningless for purposes of determining the applicability of the Short-Form Merger Statute to the World Focus/Aegis merger. Consequently, under *Glassman*, Mr. Matulich's sole remedy was to seek a valuation of his shares under the Appraisal Statute, and his complaint asserting a breach of fiduciary duty on the part of the directors was dismissed.

2. *Berger*

In *Berger v. Pubco Corporation* ("*Berger*"),[5] the Chancery Court held that the notice required to be provided to minority shareholders in connection with a short-form merger must, among other things, disclose all material information relevant to their decision whether or not to seek an appraisal, and then fashioned a "quasi-appraisal" remedy for the minority shareholders when it determined that they had been given insufficient information on which to make an informed decision.

Background and Claims

In November 2007, the minority shareholders of Pubco Corporation ("*Pubco*"), a privately-owned Delaware corporation, received a notice of appraisal (the "*Appraisal Notice*") announcing that a corporation controlled by Pubco's president and sole director, which owned 90% of the stock of Pubco ("Parent"), had executed a short-form merger cashing out the minority shareholders at $20 per share. The Appraisal Notice contained certain information in addition to the merger price, including information about the nature of Pubco's business, an officer listing, the number of shares and classes of stock, a description of related business transactions and copies of Pubco's most recent interim and annual financial statements.

Unhappy with the merger consideration, Barbara Berger, a minority shareholder, filed a class action lawsuit with the Chancery Court. Ms. Berger, citing a number of disclosure deficiencies in the Appraisal Notice, claimed that the class members were entitled to receive the difference between the price actually paid in the merger and the fair value of their shares, regardless of whether or not the class member had properly demanded appraisal under the Appraisal Statute. Specifically, Ms. Berger alleged that Parent and Pubco had failed to attach a correct copy of the Appraisal Statute to the Appraisal Notice (as required by the Appraisal Statute), and cited a number of deficiencies in the disclosure provided within the Appraisal Notice, including: (i) failure to disclose Pubco's plans or prospects; (ii) the provision of only a scant description of Pubco with no meaningful discussion of its actual operations; (iii) failure to disclose Pubco's finances by division or line of business; (iv) failure to discuss how Pubco's sizeable holdings of cash and securities had been, or were going to be, utilized; and (v) failure to disclose how Parent had formulated the merger price.

Deficiencies in the Notice

The Chancery Court's opinion began by noting that the Short-Form Merger Statute "does not impose onerous burdens on parent corporations." The Chancery Court also noted that, generally, whenever shareholders of a Delaware corporation are asked to take action, disclosure must be made of any fact where there is "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." In the short-form merger context, "[w]here the only choice for minority shareholders is whether to accept the merger consideration or seek appraisal, they must be given all of the factual information that is material to *that* decision." The Chancery Court found the Appraisal Notice to be deficient in two respects: *first*, an outdated version of the Appraisal Statute had been attached to the Appraisal Notice — the Appraisal Statute had been updated effective August 2007, but the version attached to the Appraisal Notice did not reflect those changes — and, *second*, the Appraisal Notice did not explain how Parent had formulated the merger price.

With respect to the second deficiency, Parent argued that, because it had no obligation under the Short-Form Merger Statute to set a fair price, disclosure of the methodology by which it actually set the consideration was not necessary. The Chancery Court, however, construed the issue not as one of *necessity*, but of *materiality*. Focusing on the fact that there was no public market for Pubco's stock to serve as a gauge of value, the Chancery Court stated that while "picayune details about the process ... used to set the price" need not be disclosed and the methods employed in determining price for long-form mergers are not required, "the minority shareholders of an unregistered, non-reporting company are entitled to know at least whether the parent did or did not use such methods when setting the merger consideration, because such a fact would have assumed actual significance in the deliberations of the reasonable shareholder faced with the decision of whether or not to trust and accept the price offered by the

[5] 2008 WL 2224107 (Del. Ch., May 30, 2008).

parent." Specifically, the Chancery Court observed, the minority shareholders should have been told "in a broad sense what the process was, assuming [the parent corporation] followed a process at all and did not simply choose a number randomly."

Quasi-Appraisal Remedy

In light of these disclosure deficiencies, the Chancery Court determined that the minority shareholders had sustained "irreparable injury." Because, as a matter of law, rescission is not available in the context of a short-form merger that becomes effective *before* the offending disclosures are made, the Chancery Court invoked its broad equitable powers to fashion a quasi-appraisal remedy that would place the minority shareholders "in the position they would have been in but for the … inadequate disclosure of material facts."

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3. *Radmore*

In *Radmore v. Aegis Communications Group, Inc.* ("*Radmore*"),[6] a second case arising out of the World Focus/Aegis short-form merger that was the subject of the *Matulich* decision discussed above, the U.S. District Court for the Eastern District of Pennsylvania (the "*District Court*") rejected an attempt by a minority shareholder of a Delaware corporation that was party to a short-form merger to circumvent the Appraisal Statute by bringing a claim sounding in fraud in a Pennsylvania state court.

Background and Claims

After removing the case to the District Court, the defendants filed a motion to dismiss for, among other things, failure to state a claim.

Appraisal as the Sole Remedy

In considering whether Mr. Radmore presented a valid claim, the District Court looked to the *Glassman* standard that, "absent fraud or illegality," the sole remedy available to a minority shareholder challenging a short-form merger is an appraisal proceeding before the Chancery Court. Furthermore, the District Court stated that under the Federal Rules of Civil Procedure, a claim of fraud "must state 'the date, place or time of the fraud,' or otherwise inject 'precision or some measure of substantiation into [the] allegations of fraud'".[7]

[6] 2008 WL 5129895 (E.D. Pa., December 4, 2008).

[7] Citing *Lum v. Bank of Am.,* 361 F.3d 217, 224 (3d Cir. 2004), Fed. R. Civ. P. 9(b).

alleged insufficiency of the consideration), the District Court had little difficulty in dismissing his claim. In so ruling, the District Court refused to provide an alternative avenue for a fairness review of Delaware short-form mergers by Federal or other state courts.

The Bottom Line

The Delaware Supreme Court's decision in *Glassman* established the principle that, absent fraud or illegality, a minority shareholder's sole recourse in challenging a merger effected under the Short-Form Merger Statute is to seek a valuation of shares under the Appraisal Statute. Thus, the issue whether the Short-Form Merger Statute is indeed applicable to a merger of a 90%-controlled corporation with its parent directly impacts the ability of minority shareholders to challenge such a transaction.

In *Matulich*, the Chancery Court drew a fine line between the statutory right to vote on a merger and the right to participate as a member of a class in the exercise of contractual approval rights in order to uphold the applicability of the Short-Form Merger Statute to a parent-subsidiary merger. As a result, the minority shareholders were not permitted to pursue breach of fiduciary duty claims against the defendant directors, but instead were limited to seeking a valuation of their shares under the Appraisal Statute. Similarly, in *Radmore*, the District Court, in ruling that a dispute over valuation cannot, in and of itself, establish grounds for fraud, refused to provide an alternative avenue to the Federal courts or state courts other than the Chancery Court, for a review of the fairness of consideration paid to minority holders in Delaware short-form mergers. Finally, in *Berger*, the Chancery Court's crafting of a quasi-appraisal remedy closely approximating the actual process set forth in the Appraisal Statute to address disclosure deficiencies in the notice of appraisal reinforced the principle that, absent fraud or illegality, an appraisal proceeding is the only remedy for a disappointed minority shareholder in a short-form merger.

In sum, the recent *Matulich*, *Berger* and *Radmore* decisions strike a common theme in support of the primacy of the Short-Form Merger Statute: while the courts will interpret the Short-Form Merger Statute in order to stymie attempts by minority shareholders to evade its applicability, and that of the Appraisal Statute, they also will take extraordinary steps to preserve the benefits of those statutes for minority shareholders who may have lost their right to seek an appraisal due to non-conforming notices or inadequate disclosures.

Section 13(d): The Challenges of "Group Membership"

By Mary Gill, Partner, and David O'Neal, Associate, Alston & Bird LLP[1]

When is an individual or entity that acts as a group with others for purposes of acquiring, holding, or disposing of securities of an issuer deemed part of a "group" as defined in Section 13(d) of the Securities Exchange Act (the "Exchange Act") and considered a "person" required to separately file a Schedule 13D pursuant to Rule 13d-1 promulgated under the Exchange Act?[2]

[illegible]

As a result, the Eleventh Circuit held that persons that did not beneficially own any shares of the subject class of equity securities were not required to file a Schedule 13D.[6] For the reasons discussed herein, counsel should be cautious, however, in relying too heavily upon *Hemispherx* or *Rosenberg* in advising their clients.

Understanding Section 13(d) of the Exchange Act

In 1968, Congress enacted Section 13(d) as part of the Williams Act, which sought to ensure that an issuer receives notice when a substantial amount of its stock is being accumulated.[7] To effectuate this goal, Section 13(d)(1) requires "[a]ny *person* who, after acquiring directly or indirectly the beneficial ownership of any equity security . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class" to file a Schedule 13D with the Securities and Exchange Commission ("SEC") within ten days of the acquisition.[8]

[illegible]

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Rule 13d-3 defines a beneficial owner as "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares" "[v]oting power which includes the power to vote, or to direct the voting of, such security" and/or "[i]nvestment power which includes the power to dispose, or to direct the disposition of, such security."[10] Interestingly, while the definition of beneficial ownership focuses on the sole or shared power to vote or dispose of securities, Section 13(d)(3), which defines a "group" as a "person" for purposes of Section 13(d) and the rules promulgated thereunder, focus on collective efforts for the purpose of acquiring, holding, or disposing of securities:

> When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person" for the purposes of this subsection.[11]

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[1] The authors are members of the Securities Litigation Group in the firm's Atlanta office. The authors are grateful for the comments of Kevin Miller, a partner and member of the Corporate Transactions and Securities Group in the New York office of Alston & Bird LLP.

[2] 15 U.S.C. § 78m(d); 17 C.F.R. § 240.13d-1.

[3] *Hemispherx Biopharma, Inc. v. Johannesburg Consol. Invs.*, 553 F.3d 1351 (11th Cir. 2008).

[4] *Id.* at 1362.

[5] *See Rosenberg v. XM Ventures*, 274 F.3d 137 (3d Cir. 2001).

[6] *Hemispherx*, 553 F.3d at 1363-66.

[7] *Id.*

[8] 15 U.S.C. § 78m(d)(1) (emphasis added).

[9] *Id.*

[10] 17 C.F.R. § 240.13d-3(a).

[11] 15 U.S.C. § 78m(d)(3).

Rule 13d-5(b)(1) essentially provides that any "group" as defined in Section 13(d)(3) shall be deemed to have acquired beneficial ownership of all equity securities beneficially owned by the members of the group as of the date of formation of the group.[12]

The *Hemispherx* Decision

The Eleventh Circuit decision arose from an attempted hostile takeover of Hemispherx Biopharma, Inc. ("Hemispherx") by two South African companies and certain officers in those companies (collectively "South African Defendants"), none of whom owned shares of Hemispherx, allegedly acting in concert with an individual who controlled a significant block of Hemispherx stock.

Hemispherx was a company engaged in the manufacture and clinical development of pharmaceuticals used in the treatment of viral and immune disorders. Hemispherx had granted a license for the development, manufacture, use, and sale of certain products to the South African-based company Bioclones (Proprietary) Limited ("Bioclones"). Bioclones proposed that the two companies merge in [illegible] 2007. Hemispherx subsequently claimed that its due diligence uncovered numerous misrepresentations on the part of Bioclones and the proposed merger did not occur.

None of the South African Defendants ever purchased any Hemispherx shares. Hemispherx claimed, however, that the South African Defendants were colluding with Bart Goemaere ("Goemaere"), a consultant who controlled 30 percent of Hemispherx' shares, to drive down the price of Hemixpherx' shares and ultimately effect a hostile takeover of the company. As alleged in the complaint, the South African Defendants and Goemaere agreed to act as a "group" to acquire Hemixpherx stock. Hemispherx claimed that by virtue of this agreement between the shareholder Goemaere and the South African Defendants, the defendants collectively "controlled" the voting of Geormaere's shares and were thus "beneficial owners" of those shares under Section 13(d) of the Exchange Act. By virtue of this putative agreement, Hemispherx alleged, *inter alia*, that the South African Defendants beneficially owned Goemaere's shares and violated Section 13(d) by not filing a Schedule 13D with the requisite disclosures. The district court dismissed with prejudice Hemispherx' Section 13(d) claims against the South African Defendants on the grounds that Hemispherx did not adequately allege beneficial ownership.

The precise issue before the Eleventh Circuit was whether the complaint failed to state a claim against the South African Defendants under Section 13(d) because those defendants did not beneficially own any Hemispherx shares and consequently should not be deemed members of a "group" for purposes of Section 13(d).[13] The Eleventh Circuit held that the South African Defendants were not members of a "group" for purposes of Section 13(d) because they did not beneficially own Hemispherx shares and consequently were not required themselves to file a Schedule 13D and affirmed the district court's dismissal with prejudice of the Section 13(d) claims.[14]

However, the Court confirmed that Goemaere, the individual defendant who held over five percent ownership in Hemispherx, was required to file a Schedule 13D.[15] Goemaere, in his Schedule 13D, would be required to disclose certain information regarding agreements and arrangements with other persons with whom Goemaere was acting in concert, including the South African Defendants. [16] Goemaere's Schedule 13D filing, however, would not contain all of the detailed specific information regarding the South African Defendants that would have been required to have been disclosed by the South African Defendants in separate Schedule 13D filings.

The Eleventh Circuit's Analysis

The issue of whether individuals or entities that do not beneficially own any subject security can be members of a "group" for purposes of Section 13(d)(3) and required to separately file a Schedule 13D under Rule 13d-1 was one of first impression in the Eleventh Circuit.[17] In analyzing this issue, the Eleventh Circuit looked first to the plain language of Section 13(d). The Eleventh Circuit determined that whether beneficial ownership of stock is required for group membership within the meaning of Section 13(d)(3) is

[12] 17 C.F.R. § 240.13d-5(b)(1).

[13] *Hemispherx*, 553 F.3d at 1361. The district court had dismissed Goemaere from the action on procedural deficiencies and therefore he was not included in the appeal of the dismissal of the Section 13(d) claims.

[14] *Id.* at 1366.

[15] *Id.* at 1365.

[16] *Id.*

[17] *Id.* at 1361.

not clear from the text of the statute. "Section 13(d)(3) does not expressly require or rule out a beneficial ownership requirement, or even mention the term 'beneficial ownership.' Nor does the applicable SEC regulation address the question."[18]

The Court of Appeals looked next to the legislative purpose behind Section 13(d) and Section 13(d)(3) and found that "Section 13(d) is intended to ensure that an issuer receives notice that a significant amount of its shares is being accumulated."[19] Section 13(d)(3) was designed "to prevent a group of persons from colluding to structure their interests in a company in a pool that would enable each individual member to avoid the reporting requirement and evade the purpose of the statute."[20]

[illegible]

Following the reasoning of the Third Circuit in *Rosenberg*, the Eleventh Circuit in *Hemispherx* concluded: "[t]he implication is, of course, that each member of the [Section 13(d)(3)] group must have something to 'pool.'"[24] Based on the statute's purpose, the court determined, therefore, that each member of a Section 13(d)(3) group must individually have "voting or other interests in the securities of the issuer."[25] The court noted that if this were not the rule, Section 13(d)(3) could be expanded beyond reason to include the "attorneys, bankers, financial advisors, and accountants" who offer assistance to those acquiring the five percent ownership of the publicly traded company.[26]

[illegible]

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Analysis of the *Hemispherx* Decision

A careful reading of the *Hemispherx* decision, and the statutes and rules at issue, reveals the potential for inconsistent results from other courts in deciding this same issue. As a result, counsel should be hesitant to rely upon *Hemispherx* in advising their clients, as other jurisdictions could reach different conclusions.

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[18] *Id.* at 1363.

[19] *Id.* at 1364.

[20] *Id.*

[21] *Rosenberg*, 274 F.3d 137. Because SEC regulation defines "beneficial ownership" under Section 16(b) by reference to Section 13(d), the Eleventh Circuit found the Third Circuit's analysis in *Rosenberg* was equally applicable to the analysis in *Hemispherx*. *See* 17 C.F.R § 240.16a-1(a)(1). Section 16(b) requires that insiders (*i.e.*, directors, officers, and beneficial owners of more than ten percent of an issuer's equity securities) disgorge any profits realized from the purchase and sale or sale and purchase of a company's stock if both transactions occur within a six-month period. 15 U.S.C. § 78p(b).

[22] *Rosenberg*, 274 F.3d at 144.

[23] *Id.* at 145. The *Rosenberg* court bolstered this statutory interpretation by relying upon decisions that, while not directly on point, suggested that beneficial ownership was a requirement of group membership. *Id.* at 146; *see, e.g., Bath Indus. Inc. v. Blot*, 427 F.2d 97 (7th Cir. 1970); *SEC v. Savoy Indus., Inc.*, 586 F.2d 1149, 1164 (D.C. Cir. 1978). However, as discussed *infra*, courts interpreting a substantially similar provision of the Exchange Act, Section 14(d), have not required beneficial ownership to be a "group" member. *See, e.g., MAI Basic Four, Inc. v. Prime Computer*, Inc., 871 F.2d 212 (1st Cir. 1989).

[24] *Hemispherx*, 553 F.3d at 1364 (quoting *Rosenberg*, 274 F.3d at 146) (internal quotation marks omitted).

[25] *Id.* (internal quotation marks omitted).

[26] *Id.* at 1365.

[27] *Id.* at 1364-65.

[28] As discussed above, this is arguably not sufficient. The issuer and the market are deprived of information regarding whether the South African Defendants have criminal or securities law violations and, more importantly, their plans and proposals for the issuer, which may not be the same as Goemaere and which Goemaere is not required to disclose if they are not shared.

In *Hemispherx*, the Eleventh Circuit concluded that the text of Section 13(d) and corresponding rules did not provide clear guidance on the question of whether beneficial ownership was a necessary prerequisite for Section 13(d)(3) group membership, stating:

> The text of sections 13(d)(1) and 13(d)(3) leaves open the question of whether beneficial ownership of stock is required for group membership within the meaning of paragraph (d)(3). Section 13(d)(3) does not expressly require or rule out a beneficial ownership requirement, or even mention the term "beneficial owner." Nor does the applicable SEC regulation address the question. Rule 13d-5 instructs that when a section 13(d)(3) group is formed, each member of the group "shall be deemed to have acquired beneficial ownership . . . of all equity securities . . . beneficially owned by any such persons." 17 C.F.R. § 240.13d-5(b)(1). Put another way, the regulation provides that when two or more persons act as a section 13(d)(3) group, each individual member is deemed to beneficially own the securities owned by all of them. It does not rule out a non-beneficial owner becoming a member of a section 13(d)(3) group and thereby being treated as a beneficial owner of all of the securities owned by any group member. Nor does it compel that result. The regulation simply does not say one way or the other. . . . The question, then, is whether the context of section 13(d)(3) and the congressional purpose behind it show that beneficial ownership of securities is required for group membership.[29]

The juxtaposition of Section 13(d)(1) and Section 13(d)(3) reveals, however, that Congress is explicit when it requires beneficial ownership as a condition of inclusion in the category of person. Section 13(d)(1) states as follows:

> Any person who . . . is <u>directly or indirectly the beneficial owner</u> of more than 5 per centum of such class shall . . . .[30]

Section 13(d)(3) does not contain any beneficial ownership language, providing that a "group" is formed when "two or more persons act as a partnership, limited partnership, syndicate, or other group."[31] The implication is that when the statute does not specifically include beneficial ownership, none is required. Therefore, Section 13(d)(3), which does not include specific beneficial ownership language, does not require it.

While the Section 13(d)(3) group in the aggregate must beneficially own 5 percent of the issuer's shares, there is no requirement that each individual member be a beneficial owner. Rather, the focus should be on whether the putative members of the section 13(d)(3) group "acted as a partnership, limited partnership, syndicate, or other group for purposes of acquiring, holding, or disposing of the securities of the issuer."[32]

The Eleventh Circuit's interpretation of group membership is also inconsistent with cases decided in the tender offer context, which interpreted a parallel term under Section 14(d) of the Exchange Act. Section 14(d) is a provision that was also enacted pursuant to the Williams Act, which governs disclosure required for those initiating a tender offer. Section 14(d)(1) bars an offer by "any person, directly or indirectly . . . if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than 5 per centum of such class," unless such person has filed a statement as required by the applicable rules and regulations.[33] In *MAI Basic Four, Inc. v. Prime Computer, Inc.*, the First Circuit held that Drexel Burnham ("Drexel") was a "bidder" under Rule 14d-1(b)(1).[34] As explained by the *MAI Basic Four* court, SEC Rules use the word "bidder" in place of "person" in the statutes.[35] Rule 14d-1(b)(1) provides that the term "bidder" means "any person *on whose behalf* a tender offer is made."[36] Drexel

[29] *Id.* at 1363 (citation omitted). The court's reference to "each member of the group" being required to have beneficial ownership is technically not accurate, as the text of Rule 13d-5 provides only that the "group" as a whole acquires beneficial ownership.

[30] 15 U.S.C. § 78m(d)(1) (emphasis added).

[31] 15 U.S.C. §78m(d)(3).

[32] *Id.*

[33] 15 U.S.C. 78n(d)(1).

[34] 871 F.2d at 221.

[35] Rule 14d-1(b)(1) defines "bidder" as "any person who makes a tender offer or on whose behalf a tender offer is made." 17 C.F.R. §240.14d-1(b)(1).

[36] 17 C.F.R. § 240.14d-1.

served as the investment banker and held equity positions in the companies seeking to take control of Prime Computer, Inc. ("Prime").[37]

In reaching this result, the court relied upon the cross-reference to the disclosure requirements of Section 13(d), finding that the definition of "person" in Section 14(d)(2) is identical to the definition under Section 13(d)(3).[38] The *MAI Basic Four* court determined that the "on whose behalf" language of Rule 14d-1(b)(1) incorporates the "group" concept of Sections 13(d) and 14(d) of the Williams Act.[39] Similar to Section 13(d), Section 14(d)(2) incorporates the "group" concept, which defines a "person" as "[w]hen two or more persons act as a partnership, limited partnership, syndicate or other group for the purpose of acquiring, holding, or disposing of securities of an issuer."[40]

Instead, the court's analysis focused exclusively upon whether Drexel had acted in partnership with the acquirer for purposes of acquiring, holding, or disposing of the issuers securities, which was the analysis rejected by the *Hemispherx* court. This approach would appear to be more consistent with the intent of the statutes and focus on the activity at issue—joining together for a unified purpose—which leads to the conclusion that all individuals involved in that activity should be required to file under Section 13(d).

The Bottom Line

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[37] Drexel also had the right to name one of the directors to an entity affiliated with one of the companies seeking to take control of Prime.

[38] The district court had granted Prime a preliminary injunction, holding that there had been inadequate disclosure with respect to the relationship between the companies seeking the take-over, including Drexel, particularly Drexel's relationship with these entities. The district court concluded that Drexel's relationship with these entities established that it was a "bidder" for Prime within the meaning of SEC Rule 14d-1(b)(1), 17 C.F.R. § 240.14d-1(b)(1); *MAI Basic Four*, 871 F.2d at 221.

[39] *MAI Basic Four*, 871 F.2d at 220.

[40] 15 U.S.C. § 78n(d)(2). "The definition of 'person' in §14(d)(2) is identical to the formulation found in §13(d)(3)." *MAI Basic Four*, 871 F.2d at 220.

[41] *Id.* at 221; *see also Koppers Co. v. Am. Express Co.*, 689 F. Supp. 1371 (W.D. Pa. 1988) (holding broker/dealer to be bidder under section 14(d)(2)).

[42] *MAI Basic Four*, 871 F.2d at 221; 15 U.S.C. § 78n(d)(2). The court characterized Drexel as "an active advisor-broker-financier-participant who owns less than a majority intersest in the surviving entity . . . [with] a history of close association, equity sharing, board representation and involvement from the beginning of the present offer, and where there is the possibility of the advisor-broker being the indispensable key to the offer's success." *MAI Basic Four*, 871 F.2d at 221.

[43] In fact, Drexel did not stand to obtain beneficial ownership of Prime, the tender offer target.

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