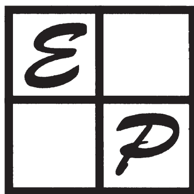

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DEAL LAWYERS

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M&A in 2012: Out with the Old, in with the New?

By Jane Goldstein, a Partner of Ropes & Gray LLP

While the existence of pent up demand (and cash) is creating hope among deal practitioners that M&A activity will increase in 2012, that hope has not turned into full blown optimism. Prognosticators range from predicting high activity levels to steady state with 2011 levels. However, while the level of activity may be difficult to predict, particularly in an election year, some trends do appear to be emerging that will drive M&A activity over the next 12 months.

Valuation Gap—Given the continued volatility of the markets, buy side and sell side continue to disagree on appropriate valuations. This will require creativity in successful deal making—likely through the use of earn-outs in the middle market in particular as well as other techniques (*e.g.*, warrants, seller debt and contingent value rights). As we have seen historically, the use of earn-outs can be fraught with disagreements and disputes and therefore lawyers should be prepared for, and draft to anticipate, post closing disputes and possible litigation.

Hostile Activity—As we have seen in 2011, both strategic buyers (Vulcan Materials/Martin Marietta) and private equity sponsors (Sycamore Partners/Talbots's) have gotten bolder with respect to non- negotiated transactions. In addition—if market volatility continues, expect activist shareholders to use proxy season and other means to encourage spin offs, divestitures and the like. We all need to update our defensive (and offensive) toolkits—bring back the 80s!! (but not the fashions please). In that regard, we are fortunate to have the Delaware Chancery Court's Airgas decision in hand.

Regulatory Hurdles—From the outset, the Obama administration threatened tougher antitrust enforcement. They have stuck to their guns! 2011 saw the failed AT&T/T-Mobile deal and the payment of a $3.5 billion reverse break up fee that "took CEO Randall Stevenson by surprise". Strategic acquirers will be wary of taking similar risks and targets will be equally wary of failed transactions and becoming "damaged goods". Expect more upfront regulatory work prior to deal announcement and pressure from clients for certainty before they will agree to large reverse break-up fees related to antitrust clearance. Regulatory challenges will also increase for companies as Dodd-Frank is implemented which has some expecting more transactions in the financial services sectors (See also "Distressed Assets")

Distressed Assets—The post 2008 world may lead sellers to divest assets for balance sheet purposes when they would rather retain them, providing opportunities for buyers of these assets. We may start to see the

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effects of the so-called "wall of debt" as loans from the 2006/2007 heyday begin to mature. Buyers will need to move quickly and have capital in hand to win the most attractive of these assets. Particularly in Europe, many experts expect to see opportunities in real estate and other sectors.

Emerging Markets/Cross Border Deals—Opportunities lay in developing markets such as Asia, Latin America and Africa. Along with opportunities in emerging markets come regulatory challenges to entry by US buyers, as well as integration challenges. Some commentators predict significant activities from mature companies with proven technology entering these new markets.

Private Equity—Sponsors are chomping at the bit to get off of the deal sidelines and we saw some uptick in activity in 2011. A combination of pent up capital, funds coming into their sunset years looking for exits and new funds being raised all point to increased activity for private equity. The debt financing markets will determine the complexion of deals in this space.

Public Company Sales Process—For those companies who either willingly or unwillingly dip their toes into the sales process, recent Delaware decisions in Airgas, Del Monte, Southern Peru and Openlane, among others, point towards the importance of process. Since buyers inherit the litigation in these deals, they would be well advised to monitor the activities of the targets' Board.

It is always risky to style yourself as a crystal ball with the answers—we will see in 12 months (as we start our predictions for 2013) how well we did.

Happy New Year to all!

Forward-Looking Statements: Deal Market Trends for 2012

By David Fox, Bob Hayward, Daniel Wolf and David Feirstein of Kirkland & Ellis LLP

With the M&A market recovery losing steam in the second half of 2011, dealmakers are faced with increased global macro-economic jitters, election year incertitude and tightened financing markets. But corporations and private funds still have capital to deploy, leading pundits and practitioners alike to be cautiously hopeful that the M&A market in 2012 may show signs of renewed vitality.

With that in mind, we look back at 2011 for lessons learned in the M&A space with implications for the coming year—from the birth of *Airgas* and further dismantling of staggered boards to the reported (but possibly not exaggerated) death of *Omnicare* and hyperbolized demise of proxy access.

Antitrust Regulators: "Not So Fast"

Antitrust risk is becoming one of the central topics of discussion among dealmakers. This year, three "3-to-2" combinations faced major opposition from U.S. antitrust agencies. Verifone's acquisition of Hypercom was only cleared after settlement of a DOJ suit requiring divestitures to a financial sponsor (after the regulators rejected a proposed divestiture remedy involving sales to the third strategic player), while H&R Block's acquisition of TaxAct failed after regulators successfully sued to block the merger of the two main rivals to TurboTax. Express Scripts' proposed acquisition of Medco remains under review by the FTC after five months, with opposition to the merger mounting. Similarly, "4-to-3" mergers are meeting with continued skepticism. AT&T's proposed acquisition of T-Mobile faces a February 13, 2012 trial date in the DOJ's suit to block the transaction. The DOJ filing came only five months after the merger was announced, a notably compressed timetable compared to the year-long reviews afforded to the XM/Sirius and Comcast/NBC combinations.

While all four transactions undoubtedly represent significant antitrust gambles in any environment, it is clear that the regulatory environment has shifted to more muscular scrutiny and enforcement than we have seen in recent years, especially at the DOJ. We believe that dealmakers will factor into their decisions about taking (and allocating) antitrust risk their views on the likely impact of the political environment in the run-up to the November elections as well as their best guess as to the outcome thereof.

BRIC by BRIC

With the continuing challenges facing the US and EU economies, 2011 saw growing assertiveness by China and India in various aspects of the M&A market. Chinese and Indian companies have become active participants in the deal market, particularly in segments such as energy, resources and chemicals. Regulators in these countries have substantially overhauled and expanded their merger review processes and, in the case of China, formalized rules on national security review; in some deals, antitrust review in China has unexpectedly become the driver of timetable from signing to closing. It remains to be seen whether these expanded reviews augur further politicization of the regulatory process given that Chinese buyers in particular have faced continued opposition to certain attempted investments in Western countries. Three recent antitrust decisions by the European Commission regarding mergers involving Chinese state-owned enterprises (SOEs) show that the European authorities are questioning whether the SOEs, among the most active Chinese M&A market participants, are sufficiently independent of the Chinese state, with implications for both determining jurisdiction (*e.g.*, should other Chinese government-controlled entities' revenues be aggregated with those of the SOE to determine if a filing is required?) and substantive antitrust review.

Extending Burger King: A "Whopper JR"?

The so-called "Burger King structure" pioneered by Kirkland & Ellis has been employed in a growing number of private equity as well as strategic acquisitions utilizing a tender offer structure where it is imperative to achieve 100% ownership virtually simultaneously with the closing of the tender, often because of financing constraints. Under this approach, the minimum condition to the front-end tender offer is set at the percentage that, when added to the maximum available top-up option, will ensure that the buyer will cross the 90% short-form threshold; if the tender fails to meet that higher minimum condition (usually measurably higher than 50%), the parties abandon the tender offer and proceed with a one-step merger using a proxy statement that is prepared and filed while the tender offer is pending.

Airgas: More Hot Air than Real Impact?

Early in 2011, the Delaware Court of Chancery handed down a ruling decisively reaffirming the validity of the "poison pill" as a defensive tactic. In a much discussed opinion, the court held that target directors may use a poison pill to fend off a hostile suitor for an extended period of time—even if a majority of shareholders want to accept a proposed deal. As a pill would inflict on the would-be acquirer prohibitive dilution and can only be removed by the sitting board, this defensive tactic is viewed as virtually ironclad so long as the target's board is opposed to the transaction.

less campaign by governance activists, only 15 of the 100 largest U.S. companies still have staggered boards—down from 54 in 2004, a trend replicated across broader cross-sections of the market. In light of this sea change in board structure, the hand-wringing about *Airgas* empowering boards to "just say no" in the face of a premium offer is increasingly unlikely to manifest itself in practice.

Reports of Omnicare's Death May Not Be Exaggerated

The controversial Delaware Supreme Court *Omnicare* decision may be on its last legs. The *Omnicare* decision precludes a target board from agreeing to a merger where a majority shareholder simultaneously signs a binding voting commitment and the board does not have a fiduciary termination right allowing them to accept a superior proposal (*i.e.*, an airtight "lock-up," and therefore in the *Omnicare* court's view, an "impermissible *fait accompli*").

In the meantime, parties have tested various work-arounds that largely achieve the same outcome without running afoul of the strict boundaries of *Omnicare*. For example, in *Orman*, the Chancery Court upheld a lock-up agreement with the majority stockholder that survived a fiduciary termination of the merger agreement for 18 months, prohibiting that controlling shareholder from supporting any subsequent alternative transaction. More recently, buyers have replaced the binding voting commitment proscribed in *Omnicare* with the execution of a binding written consent to the merger by the holders of a majority of the shares immediately after the signing of the merger agreement, subject to a [illegible] right of the parties to terminate the deal if the written consent is not delivered within 24 hours of signing the merger agreement. In practice, it is delivered immediately. In *OPENLANE*, VC Noble distinguished this structure from *Omnicare* given the absence of a binding commitment to deliver the written consents, although he showed no naivety in understanding that all parties fully and justifiably expected delivery to occur. For targets where written consent by shareholders is permitted and common for companies with controlling shareholders, *Omnicare* may be dead in practice, even if not in law.

Proxy Access: Not a Dead Letter

Much effort was expended and ink spilled during the raging debate over the SEC's mandatory "proxy access" rules that would have allowed shareholders meeting minimum holding standards to include director nominees in the company's proxy statement. When the D.C. Circuit court vacated the SEC's universal rule, the concurrent SEC amendments to Rule 14a-8 were left untouched. Under these changes, shareholders will be able to propose in the company's proxy statement bylaw amendments which would enact company-specific proxy access frameworks for director nominations (so-called "private ordering").

Activists have already taken up the gauntlet with test-case private ordering non-binding proxy access proposals being submitted thus far to a handful of companies (including Textron, Sprint Nextel and Bank of America). With these proposals requiring significantly lower ownership thresholds for nominations than the now-defunct SEC rules, the celebration of the defeat of the SEC proxy access rules may prove to have been premature and perhaps misguided. The 2012 proxy season will offer the first read on whether the private ordering approach to proxy access will gain traction with the institutional investor community—if it does, proxy access bylaws could, like the majority voting movement, quickly become the norm.

13D Beneficial Ownership Reporting: Changes on the Horizon

The requirement to file a Schedule 13D, or in the case of certain passive or institutional investments a Schedule 13G, within 10 days of exceeding the 5% ownership level has been the predominant early-warning system for accumulations of stock by investors. These SEC rules have come under increasing criticism from some quarters for not adequately adapting to the current trading realities where large stakes can be accumulated over short periods and the creative use of certain derivatives can shield an investor's full holdings from public view. To remedy these issues, proponents of changing the rules are advocating shortening the current 10-day window for investor disclosure (thereby preventing rapid accumulation above the 5% threshold during that period) and expanding the types of holdings which must be disclosed to more clearly encompass modern synthetic and derivative instruments (especially given the lack of clear guidance on these issues in the recent CSX litigation). Opponents of these changes point to a lack of evidence that tightening these rules would satisfy requirements that SEC rulemaking protect investors and promote efficiency. The SEC has intimated that its staff is nearing the end of a broad-ranging review of

the current ownership disclosure requirements and we expect that some output from these efforts will confront the investor and legal community in 2012.

Dodd Frank: More to Come

During the 2011 proxy season, corporations were forced to adapt to say-on-pay becoming part of the annual governance dance and another avenue of shareholder engagement and discontent—with limited exceptions and some accompanying nuisance litigation, most companies emerged relatively unscathed. The full impact of the new bounty-based whistle-blower regime will be closely watched. The upcoming year is likely to feature SEC rulemaking and enactment of other controversial provisions of Dodd-Frank, including the likely unexpectedly broad reach of the disclosure rules around conflict minerals and pay parity, as well as the mandatory clawback policies and tightening of compensation committee and advisor independence requirements. All of these will contribute to the continued ritualization of corporate governance and disclosure, adding fodder for those criticizing the one-size-fits-all approach to these issues.

Disclosure Settlements: A Closing Window?

Following the chilling impact of the mid-1990s litigation reforms on frivolous securities lawsuits, plaintiffs attorneys quickly found a new hunting ground in deal-related litigation—while only 12% of deals faced shareholder suits in 1999, around 85% were plagued by such suits by 2010. With this weed-like growth, a popular fee-maximizing tactic for plaintiffs counsel has been the quick resolution of the cases with "disclosure-only" settlements. In such cases, target shareholders get a bit of additional disclosure, often of questionable value, while the only monetary payment is attorneys' fees.

Delaware courts, in particular, have raised the standard for disclosure by public companies in deal-related SEC filings by providing guidance in those cases that go to trial. In doing so, they have narrowed the window for disclosure claims and concessions—i.e., as proxy disclosure has evolved and improved with court guidance, often with the intent to head off lawsuits, the enhanced disclosure has left less room for substantive disclosure-only settlements when the inevitable suits are nevertheless filed. Chancellor Strine, in a recent hearing, noted that the target for disclosure-only settlements has narrowed, which may force the plaintiffs bar to seek remedies and fees in other jurisdictions.

Multi-Jurisdictional Deal Litigation: Forum Shopping?

For various reasons, including the narrowing Delaware disclosure settlement window described above and competing perceptions of more favorable venue and litigation conditions, post-announcement deal litigation has seen increasing incidence of competing cases filed in multiple jurisdictions, with the litigants, and sometimes even the courts, fighting over the appropriate jurisdiction to resolve the dispute. This development complicates efforts to resolve these suits (whether by dismissal or settlement), often to the detriment of the shareholders of the target company. Courts, especially those in Delaware, are increasingly sensitive to the risks posed by this seeming forum-shopping and the need for a more effective mechanism to centralize deal litigation in one (most appropriate) forum. In April 2011, then Delaware Chancellor Chandler encouraged defense counsel to file motions in each relevant jurisdiction asking the judges to confer and decide the more appropriate jurisdiction to proceed. However achieved, a rational and consistent resolution to this issue is needed to ensure that the epidemic of M&A suits does not deteriorate beyond its current largely nuisance impact.

In fact, following a suggestion by VC Laster, some companies have sought to mitigate forum shopping issues by adding exclusive jurisdiction provisions into their bylaws or charter requiring that certain types of litigation (including deal-related claims) be brought exclusively in the courts of the state of incorporation (usually Delaware). Bylaw provisions are the most expedient as boards can adopt them unilaterally, but it is unclear whether these provisions will be respected when evaluated by courts outside of Delaware. Charter amendments provide a shareholder-approved alternative to a unilaterally-adopted bylaw and seem more likely to garner respect in other state courts, but are subject to the uncertain prospects of achieving stockholder approval.

NOL Ownership Changes: Not So Lost?

Code Section 382 currently applies formulaic limitations on the ability of a company to utilize its net operating losses (NOLs) in future years if it undergoes an "ownership change". In simplified form, the

existing regulations have provided that any purchase or sale by a 5+% shareholders counts towards determining whether an aggregate shift of 50% ownership has occurred. Under recently proposed IRS regulations certain sales in the market by 5+% shareholders of public companies would not count as an ownership shift. While these regulations are only proposed and a full explication of the extremely complex Section 382 rules is well beyond the scope of this note, it is clear that, if implemented, these changes could have a significant impact on the availability of NOLs for certain public companies and may require a revisiting of the necessity and propriety of at least certain elements of NOL poison pills with a 5% trigger that have been adopted by many companies to reduce the likelihood of an ownership change.

Joint Development Agreements: A Primer

By Neil Whitford and Tim Connors of Calfee, Halter & Griswold LLP

As the state of the economy and the tightening of credit have made the environment less hospitable to acquisitions, many companies are looking at other approaches to fuel revenue growth. One option is to team up with another company that has complementary capabilities and to collaborate on the development of new products or new technologies. In some cases, the best vehicle for a development project is a new, jointly owned entity. But sometimes the technical or business viability of the project is uncertain, or the parties prefer a lower level of commitment than a jointly owned entity. In those cases, the parties may decide to put their collaboration into effect through an agreement (or series of related agreements). We'll use the term "joint development agreement" in this article, but such a contract might be called a joint venture agreement, a strategic alliance agreement, a collaboration agreement, or something else. No matter its name, these agreements raise a host of critically important issues for the parties.

A company generally will not enter into a joint venture to develop a new product unless it is unable to do so on its own or there are significant advantages to partnering with someone else in that effort. For example, a company that has developed a new, cutting-edge technology may choose to partner with another company that has greater engineering expertise or manufacturing capacity. Or two companies may work together on a development program because the proposed new product is multi-faceted and neither company has sufficient knowledge or expertise to design and manufacture all of its components.

When a development project is implemented through a new, jointly owned entity, each participant has an ownership stake in the new company. By contrast, when companies pursue a development project by contract, their rights are limited to whatever is set forth in the agreement(s), as supplemented by any rights under applicable law. Consequently, the terms of a joint development agreement need to be carefully considered.

Intellectual Property Provisions

The treatment of intellectual property in a joint development agreement is vitally important. In fact, the parties may spend more time analyzing and negotiating the IP-related provisions than all of the other terms of the contract combined. An initial issue that should be addressed is how to handle each party's existing intellectual property, often called "background intellectual property." (Sometimes future intellectual property developed by a party on its own, outside the scope of the joint project, is also defined as background intellectual property.) In most cases, each party will retain exclusive ownership of its background intellectual property—even if some of that intellectual property will be used in connection with the project. Depending on the nature of the development effort, however, one or both parties may grant to the other party limited license rights with respect to its background intellectual property.

Joint development efforts often result in the creation of new know-how, technology and inventions—with respect to which there often will be intellectual property rights—patents, copyrights or trade secrets. The treatment of that new IP varies widely, depending on the relative leverage of the parties and other factors. Often, a joint development agreement will provide that each party will have an equal, undivided ownership interest in all jointly developed intellectual property. Or a distinction might be made based

on the nature of the IP, with each party being given exclusive ownership of jointly developed intellectual property that relates primarily to its core business. Even if a joint venture participant is not given an ownership interest in newly developed intellectual property, that party may be granted license rights to use the new IP during the term of the agreement, subject to certain restrictions.

If the parties to a joint development agreement fail to specify how jointly developed intellectual property is to be owned and how it can be used, or if the agreement simply provides for "joint ownership" of the jointly developed IP without further elaboration, then the parties' respective rights relating to that IP will be governed by applicable law. That can lead to outcomes that neither party intended. For example, under US law, in the absence of an agreement to the contrary, a patented invention is owned in the first instance by its inventor(s) and, if there are multiple inventors, then each one has the right to sell, license or use that invention as it sees fit, without sharing the economic benefit with the other inventor(s). To complicate matters further, all co-owners are ordinarily necessary parties to any litigation seeking to enforce a patent. In the absence of a contractual commitment to join any patent enforcement litigation, the non-suing party can prevent enforcement by refusing to join the suit. And in the absence of a contractual restriction on assignment or licensing, the non-suing party may frustrate enforcement by selling or licensing its share of the co-owned patent to the infringing party. It's easy to see how application of the fallback rules of patent co-ownership could completely undermine the parties' original intent in entering into a joint development agreement.

Now imagine that the parties jointly develop a piece of software, and that some aspects of the software are protectable by patent. As with any software, other aspects are protectable by copyright. The default rules of copyright co-ownership are different than the default rules of patent co-ownership. The joint owner of a copyright can exploit the copyright freely without the consent of the other party, but it must share with the co-owner any royalties from licensing. The result: in the absence of clear contractual provisions addressing this issue, the same software would be subject to conflicting rules regarding the sharing of royalties.

There are still more wrinkles to consider. Suppose that the project results in jointly developed IP that includes patents and copyrights in other jurisdictions besides the US. Even if the agreement provides that US law applies, the respective rights of the co-owners of a Japanese patent will be determined by Japanese law, the rights of the co-owners of a German copyright will be determined by German law, and so on. Each jurisdiction may have different, inconsistent default rules determining rights in co-owned IP.

For all of these reasons, it's critical that the agreement clearly describe each party's rights with respect to jointly developed IP. A simple statement that such IP will be "jointly owned" is not sufficient. Instead, the agreement should explicitly address, for example, any limitations on exploitation (including licensing to third parties), the sharing of royalties, the obligation to join in enforcement actions, and the responsibility for prosecution and maintenance of IP rights.

Finally, a joint development agreement should address the disposition of IP rights after the termination or expiration of the agreement. While a contractual joint development arrangement often will be simpler to unwind than a formal joint venture entity, the unwinding of a contractual relationship also can raise complex issues. In particular, careful thought should be given to the parties' rights to use jointly developed intellectual property following the termination of the agreement, specifically including any related royalty arrangements. The problems of enforcement, prosecution and maintenance also can continue after the parties have stopped actively collaborating, and the post-termination handling of these matters should be addressed explicitly in the agreement.

Business Provisions

A well drafted joint development agreement should specify the role that each company will perform in developing the new technology or product. For example, what will each party bring to the table in the form of capital, equipment, personnel and technology? Will the parties coordinate on all aspects of the development project, or will each party have specific tasks and responsibilities? It often is advisable to form a management committee comprised of representatives of both parties to guide the project from the conceptual stage to completion. Such a committee can help to establish key project milestones and related target completion dates.

Joint development agreements often include concepts that you see in other types of contracts, such as manufacturing, licensing, marketing and distribution agreements. A joint development agreement should specify how, and by whom, the new product will be manufactured. If one or both of the parties will manufacture some of its components, how will that party be compensated? If the joint development agreement provides for the grant of license rights by one party to the other, will there be any related royalty payments? How will the jointly developed products be marketed, distributed and sold to customers, and how will the parties allocate the related revenues or profits between them? Who will establish pricing for the new products, and who will bear responsibility for any related product warranty or product liability claims? All of these questions should be addressed in some fashion in the agreement.

Miscellaneous Provisions

A joint development agreement should have a stated term, and it may provide for renewal terms. As with most agreements, the parties to a joint development agreement generally will have early termination rights under certain circumstances, such as an uncured breach of the agreement by the other party. In addition, the agreement may include special early termination triggers, such as the failure of the parties to develop a prototype product within a specified period of time or a deadlock between the parties on a material matter. The agreement should clearly set forth the parties' respective rights and obligations following the expiration or termination of the agreement, not only with respect to IP rights as described above, but also with respect to manufacturing, marketing and other business obligations.

Should each party be permitted to assign its rights and obligations under the joint development agreement to a third party, such as a buyer of its business? Does the answer to that question change if the proposed buyer is a direct competitor of the other party? Also, consideration should be given to how disputes between the parties should be resolved. If a management committee has been established for the project, then that committee may serve as a useful forum for handling disputes. If not, then other alternative dispute resolution processes should be considered.

Practice Tips

Joint development agreements offer companies a means to increase their revenues without incurring the cost and potential risk of a business acquisition. But these agreements raise significant issues that warrant careful analysis. In order to reduce the danger of unintended consequences, take the time to work through the IP and business issues in detail up front. Finally, due to the many topics that need to be addressed in these agreements, and the almost unlimited options that are available to the parties, a "one size fits all" approach simply won't work. Rather, each joint development agreement should be carefully tailored to fit the parties' objectives and the nature of the development project.

Tax Diligence and Tax-Related Provisions in Acquisition Agreements

By Steven Bortnick and Tim Leska of Pepper Hamilton LLP

Tax due diligence impacts the structure of buying and selling a company. The acquisition agreement ensures that risks associated with tax liabilities discovered in diligence are appropriately allocated among the parties. By requiring the parties to be bound by certain courses of action, the acquisition agreement can also act as a mechanism to achieve identified tax goals underlying the acquisition structure. Accordingly, a lawyer navigating an acquisition must understand the tax diligence process, the tax provisions of the definitive agreement, and the manner in which structuring considerations, diligence, and negotiating and drafting the acquisition agreement all interrelate. The purpose of this article is to provide a basic understanding of these issues.

I. Overview of Tax Due Diligence

A. Parties to the Process

- *Seller.* As the party with possession of target's books and records and the party that typically is most familiar with target's assets and liabilities, the participation of the seller in the diligence process

is critical. Seller, however, would be wise to retain legal counsel to guide seller through the process and advise on the levels and form of information disclosure. Moreover, seller's legal counsel, as well as seller's financial and tax accountants, often previously advised seller with respect to prior transactions, the operation of target's business, and positions taken on tax returns, and can therefore serve as important data points in the diligence process. Seller's legal counsel and accountants can also interface with the parties on the buy-side of the transaction with respect to certain information.

- *Buy-side*. Buyer, as the party that ultimately bears the economic risk associated with the transaction, must be involved as information is uncovered to make business judgments as to the value or merits of the transaction. A buyer typically engages legal counsel and accountants to examine the information provided by seller, and summarize the information in a manner that permits buyer to make its business judgment. In additional, legal counsel and accountants are also engaged to assist buyer in integrating target into buyer's business post-closing in a tax-efficient manner.

B. Two Components of Tax Diligence

- *Traditional tax review portion—will buyer inherit tax liabilities other than those shown on target's books and records*? This portion of diligence focuses on the tax returns and tax examinations of the target, and seeks to determine whether target has timely paid all of its tax liabilities and whether it has established appropriate reserves for anticipated adjustments in the future.
- *Maximizing tax efficiencies post-closing*. This portion of diligence relates to creating a tax-efficient structure for buyer post-closing, with a particular focus on the buyer's ability to amortize a portion of its investment. This component can impact not only the structure of the deal itself, but can also lead to pre- or post-closing restructuring of the target group.

C. Inheriting Liabilities: Remembering the Structure of the Transaction and the Tax Status of Target

- *The structure of the transaction*. Whether the transaction is an asset or stock deal must be considered during the diligence process, as it impacts the liabilities that buyer will inherit.
  - In a stock sale, the buyer is acquiring a company and, therefore, will bear any liabilities of target (absent a different risk allocation in the acquisition agreement). In addition, as buyer is acquiring a company, it will inherit the company's tax history. Generally this means buyer will be required to use, with respect to the target business, target's historic tax accounting practices and be subject to target's historic tax elections. Target thus likely will be subject to audit in post-closing years on issues that are attributable to decisions made in pre-closing periods.
  - In an asset sale, the historic liabilities of seller generally can be retained by seller (absent liabilities that have given rise to a lien). Nevertheless, tax due diligence is important in asset sales because there are exceptions to this rule. For example, the bulk sale provisions of a state's law generally permit target's creditors to sue buyer for a period of time after the acquisition unless notice and other procedures were followed. Similarly, many states impose successor liability on a buyer for seller's unpaid taxes (typically sales taxes) following a bulk sale of assets if certain procedures are not followed. Moreover, if an asset sale is really the sale of the assets of an operating division rather than a specific asset, the likelihood of inheriting liabilities or being subject to decisions relating to tax accounting that occurred prior to closing is increased, because a division generally represents a business operating as a going concern (as opposed to a specific item of tangible property).
  - In a stock sale with a "Section 338 election,"[1] notwithstanding that target's shareholders are treated as selling stock, target is deemed to sell all of its assets in a taxable transaction. This deemed sale can significantly increase target's tax liability post-closing.
- *The tax status of target*. The tax status of target can also impact the liabilities that buyer will inherit. An entity that is a flow-through entity likely will have no entity level income tax liabilities; a member of a consolidated group has potential liability with respect to taxes owed by the group for tax periods during which it was a member of the group.

[1] Section 338 refers to a provision in the Internal Revenue Code (the "Code") that permits particular parties to make an election for federal income tax purposes.

D. Key Information to Request and Review

- *Corporate structure chart.* Starting with a corporate structure chart and all elections affecting the tax classification[2] of the entities of the target group provides an understanding of where entities reside within the corporate chain and their role in current planning. Understanding the relative fair market values, the outside and inside bases, and the jurisdiction of operation of each company can not only highlight potential areas of exposure, but can help establish the groundwork for integrating the target and acquirer businesses post-acquisition in a tax-efficient manner.

- *Tax returns*. Once familiar with the target's structure, a review of all income tax returns, especially for years not closed for assessment under the applicable statute of limitations, as well as accountants' workpapers and tax reserves should be undertaken.

  – The process of reviewing the target's tax returns should focus on aggressive tax positions and analyzing their likelihood of withstanding challenge. Unreasonable compensation paid by closely held corporations is a common example, and is of note as it continues to remain on tax authorities' radar and tends to be a simpler issue to identify. Other examples include undervaluation of ending inventory, participation in tax shelters (*e.g.*, listed and reportable transactions), and aggressive allocation of purchase price to depreciable/amortizable assets in prior acquisitions.

  – Adequate reserves can limit buyer's exposure to target's pre-closing aggressive tax positions, as the reserves represent a set-aside of value that can be accessed to satisfy a tax liability that arises from a particular tax position on a prior tax return. Accordingly, a tax lawyer should evaluate the adequacy of these reserves, in light of both issues that result in a permanent tax cost but those that result in a timing difference. For example, a reserve may cover the underpayment portion of a tax liability, but may not be adequate in light of time-value considerations. To test the established reserves, further information relating to the transaction giving rise to the reserve should be obtained.

- *Information related to prior transactions.* Information such as prior rulings, opinions, and appraisal reports, relating to all prior significant acquisitions and dispositions of target should be reviewed. Potential exposure in these transactions can arise either from the structure of the transaction itself or with respect to more discrete issues, such as the allocation of purchase price in the transaction.

- *Audits—what have tax authorities been investigating*? Inquiries should be made as to the status of all examinations and the results of reviews in prior audits. In addition to identifying potential liabilities, the results of past audit reports can be compared with the reserves established by target to provide a sense of the aggressiveness of target in tax matters.

- *State and local tax issues should not be overlooked.* State and local taxes present often overlooked areas of potential exposure. These taxes include not only income taxes, but also sales and property taxes. In addition, given the ease of transacting business in multiple jurisdictions in today's economic environment, many targets may be subject to taxes in multiple localities but may not be properly reporting their income to those taxing authorities. Thus, buyer should carefully review, for example, the target's state income tax position and the manner in which it apportions its income between states where the target engages in business. Sales tax exemption certificates also should be requested if target is not charging sales tax on the grounds of a resale exemption.

- *Information related to specific aspects of target's structure and tax reporting*. A review of target's tax returns can trigger supplemental diligence requests.

  – For example, if it is determined that target has non-US subsidiaries, the buyer's tax lawyer should ensure that target is properly filing all information with respect to its subsidiaries (*e.g.,* a US shareholder of a controlled foreign corporation must file IRS Form 5471 or face a $10,000

[2] "Eligible Entities" are permitted to elect their classification as a corporation, partnership or disregarded entity for federal income tax purposes by filing Form 8832. Moreover, certain qualifying entities that are classified as corporations can elect to be taxed under Subchapter C of the Code (default treatment, which results in taxation at the entity level and again at the shareholder level upon distributions and stock sales) or under Subchapter S of the Code by filing Form 2553 (resulting in "flow-through" treatment where the income of the corporation generally is taxed only once in the hands of the shareholders).

per failure penalty). Foreign tax credit calculations also should be obtained, as foreign tax credits often serve as both an area of exposure, but also one for post-closing planning.

– An S corporation target is another example of when additional information will be needed that relates particularly to target's structure. A review of all potential issues that could have caused the S election to have previously terminated is necessary. These issues include (i) confirmation that the corporation has only eligible S corporation shareholders, (ii) that the number of shareholders is within the S corporation limits, and (iii) that the S corporation has issued only one class of stock.

  - If target's S status previously terminated, target is liable for corporate-level taxes for all periods not closed by the statute of limitations subsequent to the termination. As target likely has been paying no tax as it viewed itself as a "flow-through" entity, the potential liability for these unpaid taxes could be substantial.
  - Moreover, as will be discussed below, the parties' ability to make a Section 338(h)(10) election with respect to the transaction would be foreclosed as a result of a prior termination of S status.

E. Structure Considerations: Building a Structure to Promote Business/Tax Efficiencies Adds Value to the Deal

- *Integration of businesses post-closing in a tax efficient manner*. The ability to integrate target's and buyer's business tax efficiently will depend, in part, upon what tax counsel determined in the tax review phase of diligence. For example, whether mergers between entities can qualify as tax-free may depend upon the tax classification of the entities. If consolidated returns are not filed, the location of debt financing in the structure becomes very important. Thus, buyer and its counsel must consider techniques that increase interest expense where it can be most efficiently used, which can only be known by buyer after tax diligence has been conducted.

- *Eliminating inherent inefficiencies*. Buyer's tax counsel should consider whether there are inherent inefficiencies in the structure which can be eliminated prior to or at closing. For example, a US buyer that is acquiring a foreign target with a US subsidiary may prefer to buy the US subsidiary directly rather than have a US-Foreign-US structure. The flexible check-the-box regulations, which generally permit elective tax classification of entities, may provide a simple way to eliminate inefficiencies or more effective integration.

- *Transforming a stock deal into an asset deal for tax—the Section 338 elections*. A Section 338 election or a Section 338(h)(10) election creates a deemed asset sale for tax purposes.

  – Specifically, target is deemed to sell all of its assets to a newly formed corporation in a taxable transaction. As a result of this deemed sale, target is stripped of its tax history, as the new corporation that is deemed to acquire assets is considered to come into existence immediately after the transaction. This means that all of target's historic earnings and profits will be eliminated, making future distributions from target to buyer less likely to be classified as dividends. Moreover, as a result of this deemed sale of assets, target acquires a fair market value basis in its assets. This means that target will be able to depreciate/amortize assets based on this (typically higher) fair market value basis.

  – These elections are only available in certain defined transactions, and there are certain tax costs arising by reason of the elections. Generally, both elections are only available where a corporation acquires by purchase stock comprising 80 percent or more of both the value and voting rights of the corporation within a 12-month period. A Section 338(h)(10) election contains the further requirement that the target be (i) an 80-percent owned subsidiary in an affiliated group of corporations or (ii) an S corporation.

  – By analyzing the structure of target and its tax attributes, the tax diligence process quantifies the benefits/costs of the elections and is therefore fundamental in determining whether these elections will be incorporated into the deal terms.

II. The Purchase Agreement

The purchase agreement can come in a variety of forms to match the structure adopted by the parties. The agreement can be an agreement and plan of merger (for either a taxable or tax-free forward or reverse merger), a stock purchase agreement, or an asset purchase agreement. Merger agreements are typically used in lieu of stock or asset purchase agreements where the merger eliminates the need to obtain shareholder or third party consents, or, in the context of a stock deal, where the number of shareholders that would need to be parties to the acquisition agreement cause the merger form to be more efficient. Regardless of the form of agreement, typical agreements contain three types of provisions that are of particular interest to the tax lawyer: (1) tax representations, (2) tax covenants, and (3) tax indemnities.

A. Tax Representations and Warranties

1. *Tax representations can serve three purposes for Buyer*

- *Tax representations further the due diligence process*. Tax representations draw out facts about target that may not be apparent from the buyer's review of the documents seller provided. Tax representations can provide a direct answer from seller.

- *Breaches of tax representations may permit the termination*. The acquisition agreement may provide that it is a condition to buyer's obligation to close that seller's representations be correct as of closing, such that buyer can choose not to close the transaction if a breach of a representation is discovered prior to closing. Typically, seller negotiates for the breach to be material in order for the breach to give rise to a termination of the agreement.

- *Tax representations can be a bridge to indemnity claims*. Tax representations may serve as the trigger that provides buyer with an indemnification right, thereby serving to allocate risk to the seller. However, seller may negotiate for a disclosure of a breach (or potential breach) to limit the ability of buyer to claim indemnification for liabilities arising from the disclosed item.

  – These purposes should be considered together when drafting the agreement. For example, although a tax representation may serve a diligence function, it must be negotiated in light of the indemnification provisions. If the buyer has obtained a full tax indemnity, the comprehensiveness of the tax representation may be less important than if buyer is indemnified only to the extent of a breach of a representation.

2. *The role of Seller's counsel is to negotiate representations and to limit the breadth of tax representations*

- *Communicate with accountants/tax directors*. Because most outside counsel often are unfamiliar with target's internal tax picture, it is important for seller's counsel to speak with target's tax return preparers and internal tax directors about each of the requested tax representations. Such discussions are important for two reasons: (i) if an underlying issue exists which the representation addresses, the approach seller wishes to take in raising the issue with buyer should not be undermined by seller's counsel uninformed response to buyer's request; and (ii) a particular representation, even if not off-market or generally unreasonable, may expand the scope of an indemnification package beyond what was agreed to in the business deal.

- *What role will disclosure play?* A threshold decision for seller is whether to seek to limit the representations based upon disclosures (i.e., no breach if item disclosed). In addition to the fact that buyer may not permit a disclosure to bar an indemnity claim, a seller must consider/weigh disclosure against [illegible] audit risks and ultimate exposure for the underlying issue.

- *Will representations be limited by qualifiers*? The debate then moves to knowledge and materiality qualifiers in the tax representations. Buyers generally prefer sellers to represent without qualification (to serve the diligence function of uncovering all potential issues), whereas sellers seek to limit the representations provided (a certain amount of uncertainty is inherent in any transaction).

3. *Definitions of Taxes and Tax Returns*

- *The definition of Taxes and Tax Returns are important.* These definitions limit the scope of the substantive representations relating to taxes.
  - Generally, interest, penalties and additions are included in the definition of taxes to protect buyer against all facets of a tax liability.
  - Whether, and the manner in which, taxes of others are included is an item for negotiation. For example, contractual provisions for taxes, like those contained in financing agreements, may be implicated in the definition of taxes if seller's counsel is not careful.

4. *Three fundamental tax representations*

- *All tax returns required to be filed have been filed, and are true, correct and complete*. The issues that surround this representations are: (1) whether the representation should cover all tax returns or only "material" tax returns; (2) whether the correctness prong of the representation should be free of materiality limitations or whether the representation should be limited so that the returns were true, correct, and complete in all "material" respects; and (3) to ensure that the representation only covers what is being sold and purchased.[3]
- *Target has paid all taxes required to have been paid and reserves for tax liability are adequate.* Buyers typically seek to clarify that taxes were timely paid, and that the representation relates to all required taxes, whether or not the tax was actually shown on the tax return. Sellers typically seek to limit this representation to material taxes, although it is not uncommon for sellers to seek to represent only that taxes shown on the return have been paid.
- *There are no liens for taxes on the assets of target*. Because there may be an overriding tax lien covering all property, liens for taxes not yet due and payable typically are carved out of this representation. If the representation relies on the general definition of lien or permitted liens in the acquisition agreement, buyer and seller likely will need to negotiate whether liens for taxes being contested in good faith should be excepted, and if so, whether such contests must be through the appropriate proceeds and whether target has established a reserve for the taxes underlying the contest.

5. *Representations that serve diligence function*

- *Target has received no indication from a jurisdiction in which it does not file tax returns that it may be subject to tax in that jurisdiction.* This representation is redundant of the representation that all tax returns required to be filed have been filed, but this representation advances the diligence process by asking a direct question to the seller. Seller may not object to this representation as redundant, but should always remember its goal to limit the breadth of representations; for example, seller could limit this representation to only written notice from a jurisdiction, or notices received within a particular time period.
- *Target has complied with all obligations to withhold and remit taxes to the appropriate taxing authority*. This representation may be viewed as redundant to the all taxes have been paid representation (particularly if the definition of taxes includes withholding taxes), but again this representation is used to advance the diligence function.
- *Representations relating to audit history (e.g., no examination pending, no notice of intent to audit, no proposed or additional assessments, no waiver of statute of limitations to assess, etc.).* These representations further the diligence process for buyer by highlighting specific issues that tax authorities may be considering and an extended period for exposure. The common negotiation points in these representations are (1) what type of notice must target have received and (2), if a knowledge qualifier is used, whose knowledge or expectations are relevant for purposes of the representation.
- *Representations relating to post-closing detriments*. In a stock sale, buyers often try to obtain insight and protection around the deduction target will be able to claim on its tax return for the year of sale and thereafter. In other cases, due diligence may suggest there may be a particular reason for concern. Thus, buyers often request representations relating to a specific provision of the Internal

[3] However, buyer must keep in mind that there may be an overriding tax lien that covers all property of seller.

Revenue Code (*e.g.*, target's deductions will not be limited by Section 162(m) (relating to excessive compensation)). Conversely, buyers may also be concerned that target will be required to recognize income post-closing due to an event occurring prior to closing. Examples that would give rise to this result are changes in accounting methods (both voluntary and those triggered on the close), closing agreements with a tax authority, the consolidated return rules, prepayments, installment sales, and elections that permit the deferral of income (*e.g.*, Section 108(i) relating to the deferral of cancellation of indebtedness income in certain specified situations))[4].

- *Tax agreements*. Similarly, buyers need to know whether target will be bound with respect to taxes post-closing by reason of an agreement executed pre-closing. Examples include tax sharing, indemnification or allocation agreements, as well as closing agreements and other rulings issued by tax authorities. Accordingly, buyers may seek a representation relating to existence of such tax agreements or that such agreements will be terminated on or before closing.

6. *Representations relating to specific tax issues*

- *Tax attributes*. Buyer may seek to obtain insight into the specific tax attributes of the target in a stock-sale to (i) ensure it has appropriately valued the transaction and (ii) to maximize tax efficiencies post-closing (the second component of tax diligence). To obtain protection post-closing, it may ask seller to specifically identify and represent to the tax attributes of target, such as basis in assets, excess loss accounts and deferred intercompany gains under the consolidated return regulations, net operating losses, and unused tax credits. Seller may reject such a representation on the grounds that it should not make representations as to information available to buyer in its diligence, or, in any event, limit its indemnity obligation relating to this representation.[5]

- *Foreign operations*. A target with international operations significantly expands the representations a buyer must obtain. Common representations include (1) that the foreign subsidiary is not subject to tax except in the country of its formation, (2) that the foreign subsidiary has no permanent establishment outside the country of its formation, (3) either that the foreign subsidiary is not a controlled foreign corporation or that buyer will not be required to include in income any amounts that would have been included by seller pre-closing but for the application of an exception (*e.g.*, Section 951(a)(2)), and (4) that the foreign subsidiary is not a passive foreign investment company.[6] Transfer pricing representations are also important in the international context.

- *S corporation issues*. If target is an S corporation, the purchase agreement should contain a representation that target has always been an S corporation from the date of formation (or a specified later date) through the date prior to closing, or, if a 338 election is being made in the transaction, as of closing. As noted above, embedded in this representation is a host of potential pitfalls that traditional tax diligence should seek to uncover. In light of these numerous issues, the purchase agreement may contain more targeted representations designed to uncover potential S corporation qualification issues which are redundant of the broad representation above, but which advance the diligence function.

B. Tax Covenants

Covenants are promises to take action or refrain from taking an action in the future, and therefore differ from tax representations, which only seek the accuracy of a particular statement as of a particular date. Generally, there are three categories of tax covenants.

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[4] Section 108(i) permits cancellation of indebtedness income that otherwise would have been recognized in 2009 or 2010 to be deferred and included ratably over a five year period beginning in 2014. Thus, a target may potentially recognize income as late as 2018 with respect to a transaction that occurred in 2009.

[5] For a recent example of negotiations involving tax attributes, *see Marathon E.G. Holding Limited and Marathon E.G. Production Limited v. CMS Enterprises Company*, 597 F.3d 311 (5th Cir. 2010) (seller held not responsible to indemnify buyer for taxes relating to subsequent reduction in net operating losses where definitive purchase agreement did not contain buyer's requested representation relating to the amount of target's net operating loss).

[6] Under the rules applicable to controlled foreign corporations, taxpayers that are U.S. shareholders on the last day of the corporation's taxable year are required to include in income the corporation's Subpart F income. Thus, buyers that will be U.S. shareholders of a controlled foreign corporation target will be required to include the target's entire year's worth of Subpart F income, even if the buyer only acquired the stock in the last week of the corporation's taxable year. The party to bear this tax cost is a matter for negotiation in the purchase agreement.

1. *Allocation of responsibility for tax compliance*

- *Which party will prepare and file the tax returns of target*. To properly draft this covenant, it is important to know the rules for tax-year ends. These rules differ depending upon the type of entity target is for tax purposes and the nature of the tax at issue. For example, if a buyer is acquiring 100% of the units of a limited liability company (an "LLC") that is taxed as a partnership, the LLC's federal income tax period will end on the day of closing,[7] but its liability for sales, use, and property taxes likely is not connected to when closing occurs. Accordingly, the purchase agreement should address who is preparing and filing which tax returns for which periods. The negotiating issues that arise in the context of this covenant are: (1) will the non-preparing party get review/comment rights; (2) must the tax returns be prepared consistently with past practice; and (3) how disagreements among the parties as to a tax reporting position will be resolved.

- *Payment of taxes*. The party responsible for payment of the tax does not need to be the party responsible for preparing and filing the returns. For example, a buyer of corporate stock likely will demand control of the preparation for the tax return that includes the closing date, but simultaneously demand that seller bear economically the tax for the portion of the year preceding the closing date. In such case, in addition to seeking review rights over the return, seller will need to determine the manner in which to fund the tax. At a minimum, this funding must be coordinated with any working capital adjustment contained in the acquisition agreement, but seller may simply want buyer to make an indemnity claim for the unpaid tax because this process defers payment until a later date and may also subject the obligation to the general limitations on indemnity (discussed below).

  – The acquisition agreement should contain a provision allocating taxes to the pre- and post-closing periods, so that the parties agree to the manner in which taxes will be borne ahead of time. Similarly, the agreement should contain a provision specifying which party bears the transfer taxes, if any, imposed on the act of the transfer of target by buyer to seller to avoid issues arising after the deal is done.

- *Cooperation*. Typically, each party agrees to cooperate with the other to enable the other party to fulfill its compliance-oriented duties. This includes making available any information in its possession or access to its personnel, but the requirements for information retention, notification before destruction, and the responsibility for the costs of such production/retention can make this apparently straightforward provision one of contention. Following from this covenant is an agreement regarding who controls audits: while purchase agreements usually provide a general process for dealing with third party claims, the special nature of tax investigations often leads the parties to reach a specific agreement for tax audits. The party with a potential responsibility for the claim (economically or through the indemnity provision of the agreement) will want to control the tax audit, but where the result of such audit can impact future tax contests, a buyer that is fully indemnified for the tax at issue may nevertheless seek control or access.

2. *Obtaining a specific tax result as part of the transaction*

- *Covenants to assure the intended characterization of the transaction itself.*

  – These covenants are most common in transactions structured as tax-free reorganization between two corporate entities. For example, each party would agree to take reasonable steps as needed to ensure the transaction will qualify as a reorganization, to not take or fail to take any action that would jeopardize that status, and to file all tax returns consistent with that status.

  – Another common example is a "qualified stock purchase" where the parties agree to make a Section 338(h)(10) election (an election to effectively convert a stock sale into an asset sale for tax purposes). In this instance, covenants would be included setting forth the terms for the execution and filing of the election, the structure of the deal should the election not be available (most common when target is an S corporation), the allocation of the purchase price among

[7] *See* Rev. Rul. 99-6, 1999-1 CB 432, *Situation 2* (concluding that a tax partnership terminates and must file a final return when 100% of its interest are sold to single buyer). The tax year of a corporation does not close as a result of the sale of its stock, unless the corporation was a member of a consolidated group or was an S corporation that ceases to be an S corporation following the sale.

the assets of the target, and an allocation between buyer and seller of the extra costs incurred, if any, by reason of the election.

3. Actions of target during executory period

- *Covenants to ensure condition of target does not change in the period between signing and closing*. From a tax perspective, buyer wants to know that the facts it learned during due diligence are not going to change by actions taken by sellers or target during the period between signing and closing. Consequently, buyers will often prohibit (often without the prior written consent of buyer) sellers from taking certain actions that relate to taxes. For example, target may covenant that it will not make, change or revoke any tax election. Another example is prohibiting target from filing any amended tax return or to settling any tax matter. Although these elections do not appear to be controversial, seller's counsel should always check with target's tax return prepares and in-house tax staff to make sure this covenant will not unduly restrict target, particularly where target is on the verge of concluding a tax examination, or, if target is expected to undertake a particular transaction, seller's counsel can obtain buyer's waiver for that particular transaction as part of the agreement.

C. Tax Indemnification

- *Defining the indemnity*. The first issue the tax indemnification provision should address is for what claims relating to taxes are sellers providing indemnification. Where target is a public company, typically no tax indemnity is provided because public companies are subject to a greater degree of regulation and public disclosure. In private transactions (including the acquisition of a particular division of a public company for which separate financial statements and disclosures are not prepared) sellers may not offer a separate tax indemnity, arguing that their obligation should only arise under the general breaches of representations and warranties provision. Buyers, on the other hand, may craft a specific indemnity to cover all taxes of the target for periods ending on or before closing, including the pre-closing portion of a tax period that begins before, but ends after, the closing date. Buyers may also include indemnity for taxes of others for which target could be held liable, including as a transferee, successor, or other applicable law (*e.g.*, the consolidated return regulations). This provision of the agreement therefore tends to be the most heavily negotiated provision of the agreement.

- *Limitations on the indemnity*. Once an indemnifiable claim is defined, the purchase agreement often sets forth other limitations on when an indemnified party can be paid.

  - Liabilities taken into account in determining a working capital adjustment should reduce the indemnity, as seller has already borne the cost of the liability through the purchase price adjustment.

  - Baskets (or floors) and caps are also common in purchase agreements. A basket prevents payments from being due unless the aggregate indemnity claims exceed a specified dollar amount. A cap causes the indemnifying party's obligations to cease once it has paid a specified dollar amount. Tax counsel must work with his or her client to determine whether taxes should be subject to these limitations.

  - Setting forth survival periods for claims is another means to limit indemnity. Generally, the survival period for tax claims survives the closing until some specified period of time after the applicable statute of limitations has expired. Shorter periods, however, can be negotiated, and there is no requirement that the survival period for one type of tax (*e.g.*, income taxes) be the same as the period for another type of tax (*e.g.*, property taxes).

- *Right to indemnification is only as good as the ability to collect*. An indemnified party must remember the practical issue of obtaining cash from the other party. To address this concern where the purchaser determines that sellers may not have the resources to satisfy potential claims, holdbacks, set asides (*e.g.*, against or deferral of seller's funded purchase price) and escrows are usually incorporated into purchase agreements. In this provision, the purchaser will set aside a portion of the purchase price until the indemnity period, or some portion thereof, has expired. An issue to keep in mind in this context is identifying which party will be taxed on the earnings of the escrow; a simple solution,

regardless of the party bearing the tax, is to permit the escrow to release a portion of the earnings to the party bearing the tax to give that party the cash necessary to satisfy the tax.

III. Conclusion

Every deal is different. Every target is different. Accordingly, the due diligence process and the negotiation and drafting of an acquisition agreement will always provide different and new experiences. There can be, however, a basic framework for approaching due diligence and documenting the deal as it evolves. This outline, which is not intended to be comprehensive, should provide a basic approach to conducting diligence and should identify the most common tax provisions a deal lawyer should anticipate addressing in the final agreement.

Delaware Court of Chancery Seeks To Narrow *VeriFone* With Potential Unintended Consequences

By T. Brad Davey and Jordan Adam Braunsberg of Potter Anderson & Corroon LLP*

In its recent decision in *Central Laborers Pension Fund v. News Corp.*,[1] the Delaware Court of Chancery limited the breadth of the Delaware Supreme Court's January 2011 ruling in *King v. VeriFone Holdings, Inc.*[2] In *VeriFone*, the Delaware Supreme Court appeared to extinguish a bright-line rule that required a stockholder-plaintiff to pursue books and records, if at all, before initiating a related derivative action. Reading *VeriFone* narrowly, *News Corp.* effectively reinstates the bright-line rule with one important exception. Under *News Corp.*, a stockholder-plaintiff may only pursue books and records after commencing a related derivative action if the derivative action has been dismissed with leave to amend. Because dismissals in Delaware are almost always with prejudice, *News Corp.* may incentivize stockholder-plaintiffs to pursue derivative litigation in other jurisdictions.

The Interplay Between Derivative Suits and Books and Records Actions

Both *VeriFone* and *News Corp.* revolve around the interplay between Court of Chancery Rule 23.1 and Section 220 of the Delaware General Corporation Law. Where, as is often the case, a stockholder-plaintiff seeks to institute a derivative action on behalf of the corporation without first demanding that the directors pursue the claim at issue, Rule 23.1 requires the stockholder-plaintiff to allege particularized facts demonstrating demand futility to avoid dismissal. This pleading standard is much more onerous than that imposed by Rule 12(b)(6).[3]

Section 220 is an important resource to derivative plaintiffs seeking to satisfy that heightened pleading standard because it allows a stockholder to inspect the corporation's books and records.[4] In order to do so, the stockholder must make "a written demand under oath" and have a "proper purpose."[5] Should a corporation wrongfully refuse the stockholder's demand, the stockholder may petition the Court of Chancery for an order compelling the corporation to comply with the demand. A stockholder considering a

* T. Brad Davey is a partner and Jordan Adam Braunsberg is an associate at the law firm Potter Anderson & Corroon LLP in Wilmington, Delaware. Any opinions expressed herein are those of the authors and do not necessarily represent the views of the firm or its clients.

[1] 2011 WL 6224538 (Del. Ch.).

[2] 12 A.3d 1140 (Del. 2011).

[3] *In re Goldman Sachs, Inc. Shareholder Litigation*, 2011 WL 4826104, *5 (Del. Ch.).

[4] *Rattner v. Bidzos*, 2003 WL 22284323, *14 (Del. Ch.).

[5] 8 *Del. C.* § 220(c).

derivative action may use a Section 220 request to investigate potential derivative claims and develop facts supporting demand futility. As the Delaware Supreme Court has recognized, a "books and records request under Section 220 … is one of the primary tools at hand to obtain the necessary information before filing a derivative action."[6]

VeriFone: The Court of Chancery's Bright-Line Rule

In *VeriFone*, plaintiff filed a derivative action in a California federal court without the benefit of a books and records action and soon faced a motion to dismiss for failure to plead demand futility.[7] The federal court granted the motion to dismiss. But, it did so without prejudice and encouraged plaintiff to file a books and records action to determine whether adequate grounds existed for demand futility.[8] With that encouragement, plaintiff made a demand for books and records pursuant to Section 220. When the corporation rejected the demand, plaintiff initiated a books and records action in the Court of Chancery. The corporation moved to dismiss.

In considering the motion, then-Vice Chancellor Strine held that a soon-to-be derivative plaintiff faces two mutually exclusive options with respect to the timing of a books and records demand made in connection with a derivative suit.[9] A stockholder could file a derivative action immediately without the benefit of a books and records action or, in the alternative, seek books and records first and then file a derivative action.[10] A stockholder who selects the former option increases her chance of winning the race to the courthouse and, thus, lead plaintiff and (not insignificantly) lead counsel status. Because she is proceeding without the benefit of books and records, however, she will likely have more difficulty pleading demand futility. In contrast, a stockholder who selects the second option increases her likelihood of pleading demand futility but will, almost undoubtedly, lose the race to the courthouse. Notwithstanding these consequences, then-Vice Chancellor Strine's framework precluded a stockholder from pursuing a third option: filing a derivative action and subsequently seeking books and records.

Applying this framework, then-Vice Chancellor Strine found that the plaintiff lacked a proper purpose for his books and records demand and granted the motion to dismiss.[11] Despite the federal court's suggestion to the contrary, then-Vice Chancellor Strine concluded that the plaintiff had elected to file the derivative action without the benefit of books and records and could not change course.[12] He articulated three bases for his decision. First, filing a derivative action and then filing a books and records action is "a costly, inefficient end-run around the discovery rules applicable in a derivative action."[13] Second, filing a books and records action in one court in order to obtain discovery in another court "conflict[ed] with the well-established and sensible policies against subjecting defendants to simultaneous suits in separate forums."[14] Finally, and most importantly, allowing a such a course would "exacerbate[] the perverse incentives motivating too many representative plaintiffs' unseemly and inefficient race to the courthouse."[15]

VeriFone: The Supreme Court Responds

The Supreme Court disagreed. The Supreme Court held that the Court of Chancery's bright-line rule did not "comport with existing Delaware law or with sound policy."[16] While the Supreme Court acknowledged that Delaware courts strongly encourage stockholder-plaintiffs to seek books and records before filing derivative suits, the Court concluded that pursuing a derivative action first does not preclude a later-filed

[6] *Schoon v. Smith*, 953 A.2d 196, 208 n.47 (Del. 2008).

[7] *King v. VeriFone Holdings, Inc.*, 994 A.2d 354, 355 (Del. Ch. 2010) (observing that the Federal Court dismissed pursuant to Federal Rule of Civil Procedure 23.1, the analog to Delaware Court of Chancery Rule 23.1).

[8] *Id.* at 359.

[9] *Id.* at 356-57.

[10] *Id.*

[11] *Id.* at 366-67.

[12] *Id.* at 356-57.

[13] *Id.* at 361.

[14] *Id.* at 362.

[15] *Id.*

[16] *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1145 (Del. 2011).

books and records action.[17] The Court recognized the policy concerns surrounding the lower court's ruling but asserted that the bright-line rule of law that court had imposed as a remedy was "overbroad and unsupported by the text of, and policy underlying, Section 220."[18]

Thus, the Supreme Court's decision in *VeriFone* appeared to eliminate plaintiff's timing dilemma. Plaintiff no longer needed to choose between a hastily filed action and the strongest-possible complaint. Rather, a plaintiff could accomplish both: file a derivative action first, win the race to the courthouse, and subsequently seek books and records to bolster the original derivative complaint in an attempt to plead demand futility.

News Corp.: The Court of Chancery Replies

News Corp. is the Court of Chancery's first official response to *VeriFone*. There, plaintiff, Central Laborers Pension Fund, filed a derivative action in the Court of Chancery against the defendant, News Corp., alleging breaches of fiduciary duty in connection with defendant's acquisition of Shine Group Limited. Thereafter plaintiff filed a books and records action with two proposed purposes: investigating breaches of fiduciary duty and determining whether making a demand upon the defendant was necessary before proceeding with the derivative action.[19]

News Corp. moved to dismiss the books and records action under Rule 12(b)(6) for failure to state a claim upon which relief could be granted. News Corp. argued that the simultaneous filings of the derivative complaint and the books and records action "refute[d] any claim of a proper purpose for [Central Laborers'] inspection demand."[20] The Court agreed and cited the general proposition that "by filing its derivative complaint, [plaintiff] acknowledged that it had sufficient information to support its substantive allegations and its allegations of demand futility that would excuse prior demand on the News Corp. board — both necessary to go down the path chosen by it to challenge the Proposed Transaction."[21] Thus, the Court concluded that "a stockholder plaintiff who files a Section 220 action immediately after a derivative action is acting inconsistently."[22]

Vice Chancellor Noble found plaintiff's reliance on *VeriFone* to be misplaced.[23] In doing so, he read *VeriFone* to hold that "a derivative plaintiff whose complaint had been dismissed for failure to plead demand futility was not, on account of the mere fact that a derivative action had been filed, 'legally precluded from prosecuting a later-filed Section 220 proceeding.'"[24] Thus, the Court of Chancery understood *VeriFone* to permit a later-filed books and records action only where the derivative action had been dismissed without prejudice. Such a reading strictly limits *VeriFone's* holding to its facts.

The Court of Chancery found the facts surrounding the case before it materially different from those in *VeriFone*, because "[t]he Derivative Action ha[d] not been dismissed; no judicial action ha[d] occurred that would suggest a need or reason for further pleadings or efforts to gather important facts to support a cognizable purpose for inspection of News Corp.'s books and records."[25] Distinguishing this from *VeriFone*, Vice Chancellor Noble observed "[i]t was, in *VeriFone*, the judicial determination that the allegations were not sufficient coupled with the judicially granted leave to amend that eliminated the inconsistency that one may find in the simultaneous filing of two related actions."[26] Concluding that nothing in Central Laborers' complaint brought it within the ambit of *VeriFone's* paradigm, the Court of Chancery granted News Corp.'s motion to dismiss the books and records action.[27]

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[17] *Id.* at 1141.

[18] *Id.* at 1151.

[19] *Central Laborers Pension Fund v. News Corp.*, 2011 WL 6224538, *1 (Del. Ch.).

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.* (quoting *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1141 (Del. 2011).

[27] *Id.*

Consequences: *VeriFone*, *News Corp.* and Rule 15(a)(a)(a)

News Corp. breathes new life into the bright-line rule set forth in then-Vice Chancellor Strine's decision in *VeriFone*. As a result of Court of Chancery Rule 15(a)(a)(a),[28] however, the bright-line rule, as resurrected by *News Corp.*, will likely have a much more pronounced effect on derivative litigation in Delaware. Under Rule 15(a)(a)(a), a plaintiff faced with a motion to dismiss must either amend her complaint or stand upon her existing complaint and oppose the motion to dismiss on the merits. If the plaintiff elects the latter course and the Court grants the motion to dismiss, Rule 15(a)(a)(a) requires that the dismissal be with prejudice. Plaintiff may avoid that result only if she can show good cause for why "prejudice would not be just under all the circumstances."[29] Rule 15(a)(a)(a), thus, all but eliminates the possibility of a dismissal with leave to amend – the only circumstance, after *News Corp.*, in which a stockholder-plaintiff may seek books and records after pursuing a derivative action. As a result, a stockholder that files in Delaware faces a familiar choice: pursue a hastily filed derivative action, without the benefit of a books and records request, and win the race to the courthouse; or pursue a books and records request and then a derivative action but lose the race to the courthouse.

A stockholder-plaintiff, however, has a third option: file its derivative action in a jurisdiction that does not have a Rule 15(a)(a)(a) analog. A stockholder-plaintiff who elects this option will not face the mandatory dismissal with prejudice that exists in Delaware for derivative actions. Therefore, such a stockholder-plaintiff will be able to file a derivative action and successfully pursue a later-filed books and records action in the event the derivative action is dismissed for failure to plead demand futility. Because this option allows a stockholder-plaintiff to win the race to the courthouse and to pursue a later-filed books and records action, *News Corp.* may incentivize stockholder-plaintiffs to file in other jurisdictions. Whether this potential incentive will remain is an open question. Certain stockholders have appealed the Court of Chancery's decision in *News Corp.* to the Delaware Supreme Court. Stay tuned.

[28] Ct. Ch. R. 15(a)(a)(a).

[29] *Id.*

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