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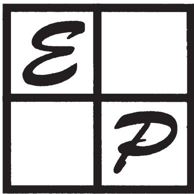

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Dealing With Activist Hedge Funds

By Martin Lipton, Founding Partner of Wachtell, Lipton, Rosen & Katz

The past ten years have seen a high and increasing level of activist campaigns. There have been more than 300 activist attacks on major companies during this period. Among the major companies that have been attacked are, P&G, McDonald's, ITW, DuPont, Motorola, Target, Pepsi, Heinz, Kraft and Home Depot. There are more than 100 hedge funds that have engaged in activism and they frequently gain the backing of ISS and major institutional investors, some of which have investments in activist funds. SEC rules do not prevent an activist from secretly accumulating a more than 5% position before being required to make public disclosure.

Hedge fund activism requires attention and warrants similar preparation as to that we recommend for responding to a hostile takeover bid. This checklist is a revision of the one I did in 2007 as a supplement to my Takeover Response Checklist. In fact, some activist attacks are designed to change management or the board of the target in order to facilitate a takeover or to force a sale of the target. Careful planning and a proactive response are critical. Failure to prepare reduces a company's ability to control its own destiny.

Among the attack devices being used by activists are: (a) proposing a proxy resolution for creation of a special committee of independent directors to undertake a strategic review for the purpose of "maximizing shareholder value"; (b) conducting a proxy fight to get board representation (note solicitation for a short slate is very often supported by ISS and when it is, is usually successful); (c) orchestrating a withhold the vote campaign; (d) convincing institutional investors to support the activist's program; (e) stock loans, options, derivatives and other devices to increase voting power beyond the activist's economic equity investment; and (f) using sophisticated public relations campaigns to advance the activist's arguments.

Prevention of, or response to, an activist attack is an art, not a science. It is essential to be able to mount a defense quickly and to be flexible in responding to changing tactics. To forestall an attack, a company should continuously review its business portfolio and strategy and its governance and executive compensation issues sensibly and in light of its particular needs and circumstances. Companies must regularly adjust strategies and defenses to meet changing market conditions and legal developments.

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This outline provides a checklist of matters to be considered in putting a company in the best possible position to prevent or respond to hedge fund activism:

Advance Preparation

- Create Team to Deal with Hedge Fund Activism
  - Basically the same team as the takeover response team: a small group (2-5) of key officers plus lawyer, investment banker, proxy soliciting firm, and public relations firm
  - Continuing contact and periodic meetings of the team are important
  - A periodic fire drill with the team is the best way to maintain a state of preparedness; the team should be familiar with the hedge funds that have made activist approaches generally and be particularly focused on those that have approached other companies in the same industry and the tactics each fund has used
  - Periodic updates of the company's board of directors

- Shareholder Relations
  - Review dividend policy, analyst and investor presentations and other financial public relations matters
  - Monitor peer group, analyst, proxy advisors like ISS, activist institutions like CalPERS and TIAA-CREF, Internet commentary and media reports for opinions or facts that will attract the attention of attackers
  - Be consistent with the company's basic strategic message
  - Proactively address reasons for any shortfall versus peer company benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers
  - Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders, paying close attention to activist funds that commonly act together
  - Maintain regular, close contact with major institutional investors; CEO and CFO participation is very important
  - Monitor ISS, CII, TIAA-CREF corporate governance policies; activists try to "piggy-back" on process issues to bolster the argument for short-term business changes
  - Maintain up-to-date plans for contacts with media, regulatory agencies and political bodies

- Prepare the Board of Directors to Deal with the Activist Situation
  - Maintaining a unified board consensus on key strategic issues is essential to success; in large measure an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance and to create divisions on the board by advocating that a special committee be formed
  - Review with the board basic strategy and the portfolio of businesses in light of possible arguments for spinoffs, share buybacks, increased leverage, special dividends, sale of the company or other structural changes
  - Schedule periodic presentations by the lawyer and the investment banker to familiarize directors with the current activist environment
  - Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the CEO
  - Avoid being put in play; recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target

- Monitor Trading
  - Employ stock watch service and monitor Schedule 13G filings
  - Monitor Schedule 13D and Hart-Scott-Rodino Act filings
  - Monitor parallel trading and group activity (the activist "wolf pack")

The Activist White Paper

- The activist will frequently approach a company with an extensive high-quality analysis of the company's business that supports the activists recommendations (demands) for:
  - Return of capital to shareholders through share repurchase or a special dividend
  - Sale or the spin-off of a division
  - Change in business strategy
  - Improvement of management performance
  - Change in executive compensation
  - Change in governance: add new directors designated by the activist, separation of CEO and Chairman, declassify the board, remove poison pill and other shark repellants and permit shareholders to call a special meeting

Responding to an Activist Approach

- Response to Non-Public Communication
  - No duty to discuss or negotiate (no outright rejection and try to learn as much as possible by just listening)
  - No duty to disclose unless leak comes from within
  - Response to any particular approach must be specially structured; team should confer to decide proper response
  - Keep board advised
  - No duty to respond, but failure to respond may have negative consequences
  - Be prepared for public disclosure by activist

- Response to Public Communication
  - No response other than "the board will consider"
  - Assemble team; inform directors
  - Call special board meeting to meet with team and consider the communication
  - Determine board's response and whether to meet with activist (failure to meet may be viewed negatively by institutional investors)
  - Avoid mixed messages
  - Gauge whether the best outcome is to agree upon board representation and/or strategic business change in order to avoid a proxy fight
  - Be prepared and willing to defend vigorously
  - The recent defeat by AOL of an activist short-slate proxy solicitation supported by ISS shows that investors can be persuaded to not blindly follow the recommendation of ISS. When presented with a well-articulated and compelling plan for the long-term success of a company, they are able to cut through the rhetoric of short-sighted gains promised by activists touting short-term strategies. The AOL fight showed that when a company's management and directors work together to clearly present a compelling long-term strategy for value creation, investors will listen.

A Year-End Rush for the Exit?
Tax Uncertainty and Transactional Planning

By David Strong and Bernie Pistillo, Partners of Morrison & Foerster LLP

A combination of pending actual and potential tax increases effective in 2013 may have a significant impact on transactional planning in the third and fourth quarters of 2012. These potential tax increases may affect deal terms and also motivate some buyers and sellers to move quickly to close transactions by year-end. Affected parties should evaluate their inventory of pending transactions and identify those transactions for which closing in 2012 may be of critical importance. Please feel free to direct any questions regarding the matters discussed in this client alert to any of the attorneys listed below under the heading *Morrison & Foerster Contacts*.

Potential Tax Increases

The "Bush tax cuts" are currently set to expire on December 31, 2012. As a result, absent affirmative Congressional action, on January 1, 2013, the highest tax rate applicable to an individual taxpayer will increase from 35% to 39.6% for ordinary income, 15% to 39.6% for dividends, and 15% to 20% for long-term capital gains. At the same time, the already enacted tax increases under the 2010 healthcare reform package will take effect. Of particular significance to transactional activity will be the new 3.8% additional Medicare tax imposed on the investment income of individuals earning more than $200,000 and couples earning more than $250,000. The healthcare reform package also increases the existing Medicare tax on wages and salaries in excess of $200,000 for individuals and $250,000 for couples by 0.9% (from 2.9% to 3.8%). Each of these potential tax increases is summarized in the table below.

Type of Income	Current Law Through 2012 (Highest Individual Rate)	New Law Beginning 2013 (Highest Individual Rate)
Ordinary Income	35%	39.6%
Dividends	15%	39.6%
Long-Term Capital Gains	15%	20%
Medicare Tax (investment income)	N/A	3.8%
Medicare Tax (wages)	2.9%	3.8%

Potential Impact on Transactions

- ***Closing Date.*** The combined effect of the sunset of the Bush tax cuts and the new Medicare tax on investment income would result in an overall increase in the effective maximum federal tax on long-term capital gains recognized by individuals by 8.8 percentage points to 23.8% (as compared to the current 15% rate). This would be a material incremental tax cost that could motivate affected buyers and sellers to push hard to close transactions before the end of 2012. In addition, the spending cuts (so-called "sequestrations") required by the Budget Control Act of 2011 and the looming prospect of another potential fight over the debt limit in early 2013 could create increasing concerns regarding the general state of the U.S. economy. Any growing concerns regarding the overall U.S. macroeconomic climate may further prompt buyers and sellers to move quickly to close in 2012.
- ***Tax-Deferred Equity Consideration.*** In light of the pending 8.8% increase in the federal tax rate on individual long-term capital gains, it may make sense for some sellers who plan to close transactions in 2012 to receive any potentially tax-deferred equity consideration on a taxable basis rather than on a tax-deferred basis. This approach may be particularly beneficial if the stock received in 2012 is likely to be sold within a relatively short period of time following the closing date, because the value of the tax deferral to the seller may not offset the cost of the effective tax rate increase. Depending

on the facts and circumstances, converting a non-taxable transaction into a taxable one often can be accomplished without changes to the economic terms and requiring only slight modifications to the legal form. A taxable transactional pattern may also have the potential to deliver incremental tax-basis benefits to the buyer, which in turn can allow the seller to press for payment of an additional premium.

- ***Escrow / Earn-Out Provisions and Installment Sale Deferrals.*** Once again, in light of the pending 8.8% increase in the federal tax rate on individual long-term capital gains, it may also make sense for some sellers to structure escrow or earn-out provisions so that payments can be accelerated to some degree in the event that the Bush tax cuts are not extended. For example, a seller might agree to receive a reduced series of one or more earn-out payments beginning on or before December 31, 2012, in the event that the 15% long-term capital gains rate is not extended, in lieu of the buyer making a potentially larger series of one or more earn-out payments that would otherwise begin sometime in 2013. Absent an actual acceleration provision of some kind, sellers can also potentially elect out of installment reporting as late as the extended due date for their 2012 returns and effectively accelerate deferred payments into income for 2012 if there is an adverse rate change (but such a strategy requires careful analysis, especially when there is a high degree of potential variability in the contingent payments that may be made). Electing out of installment sale treatment also requires planning for cash flow needs to pay the 2012 taxes that would be due April 15, 2013.

- ***Dividend Distributions.*** As previously noted, if the Bush tax cuts are not extended, the maximum federal tax rate on dividends will jump dramatically from 15% to 39.6% beginning in 2013. This could, in turn, have a significant impact upon certain types of corporate recapitalization or reorganization transactions where the cash received by a shareholder may be characterized as a dividend rather than long-term capital gain. This can occur, for example, in certain minority investment recapitalization transactions where the pre-existing shareholders receive a distribution of some or all of the newly invested cash and do not simultaneously experience a meaningful reduction in their level of ownership or control of the corporation. In such a situation, it may make sense to attempt to restructure the terms of the transaction to avoid dividend characterization. By comparison, through the end of 2012, an individual shareholder may be indifferent as between receiving consideration that is characterized as a dividend rather than long-term capital gain, given the 15% rate that is currently applicable to both types of income.

- ***Incentive Compensation.*** Finally, if Congress does not act to preserve the current tax rate structure, the highest individual tax rate on ordinary income will increase from 35% to 39.6% beginning in 2013 (or 40.5% after including the additional 0.9% Medicare tax on wages and salaries in excess of $200,000 for individuals and $250,000 for couples). As a result, a meaningful spread will continue to exist between ordinary income and long-term capital gains rates, and individual incentive compensation planning should continue to take that spread into account, as well as evaluate the benefit of compensation deferrals past 2012 in light of the increasing rates. Another continuing source of uncertainty exists in the area of incentive compensation with respect to the potential for passage of "carried interest" legislation that would tax certain flow-through capital gains at ordinary income rates. This issue may receive renewed attention in Congress in late 2012 or early 2013.

Concluding Observations

- Most commentators have remarked that Congress is unlikely to take any action with respect to tax rates prior to the November elections. After the elections, only a very short time period will remain for any potential legislative action, and during that time financial markets may be subjected to an even higher degree of uncertainty and distortion.

- Given the potential for tax increases and continued macroeconomic instability, affected parties should evaluate their inventory of pending transactions and identify those transactions for which closing in 2012 may be of critical importance. Steps should then be taken to consummate such transactions in an expeditious and tax-efficient manner. Planned transactions should also take into account the increased backlog that may develop toward year-end with respect to transactions that may be subject to regulatory approvals.

Shareholder Activism Via Board Control Often Requires Long Range View

By Derek Bork, a Partner with Thompson Hine LLP*

When we first work with an investor who is seeking to become an activist, we often hear the same initial message: "We need board control. We need it ASAP. How can we achieve it now?" Although a path to obtain board control in a short period of time is sometimes left open by a company's governance structure, this is not always the case. We have helped activists gain board control in as little as 56 days to as many as 590 days. In the cases where a quick strike is not possible, we counsel in favor of a longer term approach—one that involves obtaining minority board representation in the short-run with a strategy for achieving board influence over a longer time horizon.

Despite the unpopularity of takeover defenses in recent years, many companies have maintained formidable defenses that make obtaining control of a company's board, if not impossible, time consuming and difficult. This can often be seen with small cap companies and other public companies that, for one reason or another, have avoided the typical pressures to make governance reforms from institutional investors and proxy advisory firms such as ISS. Even some new public companies—those that are free of these pressures—are loading-up on board takeover defenses.

We recently encountered two small cap companies where shareholders were not permitted to call shareholder meetings and could not act by written consent. Both of these companies had staggered boards with three classes of directors elected over a three-year period. At each company, shareholders could increase the size of the board, but only the board could fill any newly created board seats. In each case, shareholders could remove any or all of the directors, but considerable obstacles were attached to this option. Each company had restrictive advance notice requirements for director nominations and shareholder proposals, and one company had a poison pill to boot. Absent extraordinary actions, at companies with defenses like these, there is no easy or quick path to board control.

A variety of other factors, of course, have a significant impact on whether an activist can gain control of a company's board. This includes the stature and record of the company's board and management, the company's historical financial performance, the strength of the company's strategic plan and the company's standing with its shareholders and other constituencies. Important factors on the activist's side include its credibility in the marketplace, its proposed board slate, its plans for the company and the effectiveness of its outreach to shareholders. All of these factors—in addition to the structural impediments in place at a particular company—need to be weighed when planning a campaign.

In cases where the structural impediments are high, the advice to pursue a longer path is not always well received by an investor, and some abandon their activist plans at the outset. Granted, sometimes an investor's investment strategy for a particular stock is not long-term in nature, and, faced with potential delay and uncertainty in achieving the investor's goals through activism, the investor might be wise to sell the stock and move on. However, an investor considering an activist strategy usually does so because the investor already has a longer term investment horizon in mind for the stock. In addition, the goals that investors typically desire to achieve through activism necessarily require time to carry out and produce results. Also, particularly when it comes to a large position in a small cap company, the investor may not have a highly liquid position and may be stuck in the stock for the long term. Put bluntly, the investor is already likely to be in the stock for the long term anyway.

A long range strategy in this context is not necessarily a concession for an investor. If an investor is able to negotiate for one or more board seats, the investor has an immediate seat at the table and the potential for influence. Investors often question, "How can I achieve anything if I only have one vote?" However, many investors underestimate the influence they can have through just one or two board seats. Boards most often prefer to operate in a collegial and cooperative fashion, and directors—even outsiders—who conduct themselves professionally are usually brought into the fold and treated with respect and as part of the team. Many times there are existing directors who see the need for change and are eager to align

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with a new director advocating new ideas. In addition, fiduciary duties generally compel a board as a body to consider in good faith serious questions and proposals that are raised by individual directors. This environment gives an outside director the ability to have an impact on board deliberations and decisions.

A seat on the board offers the investor other potential opportunities. A board's composition, particularly at small cap companies, is often fluid. Directors resign for any number of reasons, are not re-nominated by the board or are removed from the board for other reasons. A board may work together to bring in additional outside voices or industry experts, and these new directors might become additional advocates for change. Service on the board also provides an investor with access to important information about the company and its inner workings, which could prove useful in gaining additional board seats, engaging in a proxy contest or running the company if board control is ultimately obtained. A variety of other opportunities might arise that give the investor the ability to have greater influence—or even board control.

Inevitably, time passes quickly, both for the investor who chose the longer path and the investor who did not. The investor who abandoned activism at the outset frequently comes back to us down the road—most often after the company's performance has deteriorated further—and asks: "What can we do now?" The answer at that time is usually the same: "Let's get a seat at the table and wait for opportunity to arise."

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The Nuts & Bolts of NDAs

By Eric Wang, a Partner of DLA Piper

A nondisclosure agreement, often referred to as an NDA or a confidentiality agreement, is typically the first agreement to be entered into in a mergers and acquisitions transaction. The agreement is designed to protect the confidentiality of information exchanged in connection with the consideration and negotiation of the transaction and information exchanged in the course of a party's due diligence review of the other. In a situation where a party is presented with the other side's form NDA, a careful review is warranted.

Set forth below is a summary checklist and commentary concerning some of the more important items to consider when reviewing an NDA. The checklist and commentary refer to "Providers" and "Recipients," regardless of which part is the buyer or seller. That is because while the selling party generally is the "Provider," in some situations, such as where the buying party is issuing its equity as part of the transaction consideration, the buyer may also providing substantial amounts of confidential information to the seller for the seller's due diligence on the buyer.

Where the italicized prefaces *"Providers should"* or *"Recipients should"* advocate actions to take in your review, keep in mind that business reasons may dictate the importance of certain provisions and the lesser relevance of others. The checklist does not contain every matter you may desire to negotiate and is not a substitute for review by sophisticated M&A counsel – it is merely intended to address some of the more common issues you should be aware of in reviewing an NDA.

General

Providers and Recipients should

- Confirm that the form of NDA used is a proper one, as often parties mistakenly start with an NDA that is designed for providing information to vendors or with another short-form NDA that is not tailored for an M&A transaction.

Definition of Confidential Information

Providers should

- Confirm that the definition of "confidential information" sufficiently covers the information and materials to be provided (and, to the extent applicable, confidential information that may have been previously provided).
- Consider removing legending requirements that any written materials be marked "confidential" or that oral statements be reduced to writing and so marked to be considered confidential, to avoid accidental failures to legend leading to unprotected confidential information.
- Consider having any subset of extremely confidential information being supplied (such as pricing information, patent information, or source code) carved out and addressed separately under a special NDA implementing careful controls and procedures to limit the distribution and access of the information to those advisors or agreed upon personnel of the Recipient whom the Provider believes cannot exploit the information commercially, especially where the Recipient is a close competitor.
- Remove any "residual" clause which allows the Recipient to use, in future products or services, all information retained in the memory of the Recipient's employees which was obtained from reviewing the confidential information.

Recipients should

- Confirm that the exclusions from what is considered confidential information properly reflect the principle that information should not be protected if it was created or discovered by the Recipient prior to, or independent of, any involvement with the disclosing party.
- Consider removing legending requirements to avoid a burdened diligence process.

Use of Confidential Information

Providers should

- Confirm that there exists language limiting the use of the confidential information to that contemplated (evaluation of the specific transaction) and not for any other purpose.
- Confirm that there exists language clarifying that no license is being granted to the Recipient or its representatives to use the confidential information except for the specific purpose of evaluating the transaction, and that no license is being granted to any of the Provider's intellectual property.
- Confirm that the Recipient is responsible/liable for its representatives' proper use of the confidential information to the extent that the Provider does not request such representatives to be parties to the NDA.
- If the Provider is a publicly traded company, confirm that the Recipient will not use confidential information in violation of applicable securities laws.
- Consider implementing controls and procedures to limit the distribution and access of the information if there is extremely confidential information being supplied or if the Recipient is a close competitor, but where these factors do not arise to the level of affording treatment of the more sensitive portion under a special NDA.
- Confirm there exists language clarifying that information provided does not constitute any representation or warranty of the Provider and that such representations and warranties are limited to what is provided for in the definitive agreement.

Non-Disclosure of Discussions

Providers should

- Confirm that the NDA contains language clarifying that the fact of discussions between the parties regarding the transaction is confidential, especially if the Provider is a publicly traded company.
- If the Provider is the selling company in an auction context, attempt to retain some limited ability to disclose the fact that the Recipient is bidding or, to the extent possible, to disclose the terms of any bid made by Recipient.

Recipients should

- Confirm that the NDA contains language clarifying that the discussions between the parties regarding the transaction are confidential, including the identity of the parties and the terms of any bid if the Recipient is the acquiring company.
- If the Recipient is the acquiring company and needs financing for the transaction, obtain a carve-out allowing information to be disclosed to financiers.

Legally Required Disclosures

Providers should

- Consider requiring the Recipient to fully cooperate with the Provider in obtaining any applicable protective order if requested.

Recipients should

- Confirm there exists an exception to the NDA allowing the Recipient to disclose information which is legally required to be disclosed.

Return or destruction of materials

Providers should

- Confirm there exists language providing for the return or destruction of any written confidential information provided.
- If a copy is to be retained for archival/evidentiary purposes, confirm that this is kept by outside counsel.

Recipients should

- Consider allowing outside counsel the right to retain one copy for archival/evidentiary purposes.
- Confirm that the Recipient is permitted to destroy or certify destruction of information to satisfy obligation.

Non-Solicitation/Employment

Providers should

- Confirm that the NDA contains language providing for protection against the Recipient's solicitation of the Provider's employees for some amount of time (the typical range is six months to two years; one year is common) as well as against solicitation of former employees recently departed (six months is common).
- The Recipient may argue strongly against this because it is a large entity that will have difficulty keeping track of solicitation and hiring activities. In this case, consider these alternatives: limiting scope of non-solicit to "key" employees or those Recipient has contact with or were identified during the diligence process, or limiting the interaction between both parties' employees by restricting which Provider employees the Recipient will be allowed to contact.

Recipients should

- Consider a limiting provision that would apply only to "key" employees or employees of the Provider who Recipient had contact with or were identified to the Recipient during the diligence process.
- Confirm that there exists a carve-out for general solicitation not directed at Provider employees.
- Consider removing the provision altogether if it concerns a large entity that would have difficulty keeping track of solicitation and hiring activities.

Term

Providers should

- Consider language providing that the NDA does not expire as what is confidential now may need to remain kept as confidential many years from now.
- Consider setting an unlimited term for trade secrets.

Recipients should

- Consider limiting the NDA to a specific time period (range is generally one to five years).

Remedies

Providers should

- Confirm there exists language having the Recipient acknowledge and agree that monetary damages are insufficient to remedy breach of the NDA, and that the Provider is entitled to equitable relief in addition to any other remedies.

Miscellaneous Provisions Applicable to Providers and Recipients

- *Privileged information*. Consider language stating that disclosure is not deemed to have waived or diminished attorney-client privilege, attorney work-product protection, or any other privilege or protection applicable to the confidential information, which relies upon a form of the joint defense doctrine. Note that effectiveness of this provision is not certain.

Other

- *Binding agreement*. Confirm that language exists clarifying that the NDA does not constitute an agreement to enter into or even negotiate a transaction, as sometimes courts have found an agreement to negotiate absent such language.
- *Standstill provisions*. These provisions are only applicable where the target company is publicly traded or likely to be public soon, and, due to their complexity, these provisions should be carefully addressed and reviewed by sophisticated M&A counsel.
- *No shop*. The seller should resist provisions restricting it from shopping as these are not typically agreed to until at least a term sheet or basic transaction terms are agreed upon.
- *Export laws*. If the Providers have a particular concern about providing technical information to non-US persons, they should consider adding a provision ensuring that a Recipient complies with applicable export laws.

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It's Done: 1st Edition of Romanek's "Proxy Season Disclosure Treatise"

Wrapping up a project that Broc feverishly commenced six months ago—and poured his heart and soul into—we are happy to say the inaugural 2013 Edition of Romanek's "Proxy Season Disclosure Treatise & Reporting Guide" is done! You will want to order now so that you can get your copy as soon as you can. With over 1150 pages spanning 27 chapters, there is a detailed table of contents on TheCorporateCounsel.net to review to help give you a sense of how practical it is. You can return it any time within the first year and get a full refund if you don't find it of value. Order now on TheCorporateCounsel.net or via the enclosed flyer now.

Asset Acquisition Due Diligence: Search for Hidden Unclaimed Property Liabilities Required

*By Stanley Kaminski, a Partner of Duane Morris LLP**

Whether you are buying all of the assets of a company or merely a substantial portion of such assets, due diligence demands a review of the potential unclaimed property liabilities that may lurk within the assets acquired.

For those unfamiliar with unclaimed property, this is property owed to another and unpaid. It can be unpaid bills, uncashed checks, unpaid dividends or interest, overpaid bills or account receivables, gift certificates, unused deposits or store cards, unclaimed rebates, etc. Believe it or not, a company generally cannot just treat such unclaimed funds as found money and spend it. Rather, every state and even certain Canadian provinces have unclaimed property laws that require the "holder" (the person owing and thus holding the money) to turn over such money to the state (after a specified holding period) if the holder does not first pay such funds to the person to which it is owed (i.e., the "debtor"). With that said, there are specific rules as to which state has priority in getting the funds, and the states differ on what types of property are included or excluded from that state's unclaimed property law.

By U.S. Supreme Court edict, there are two states with a clear claim to the unclaimed funds. The first priority claim goes to the state of last known address of the debtor. However, if that state is unknown, then the second priority right to the funds goes to the state of the holder's incorporation. A controversy arises if the holder is not a corporation (*e.g.*, LLC), since some states look to the state of organization of the entity, while others look to the entity's commercial domicile, to claim a right to the unclaimed funds. Some states also argue that a third priority rule exists giving states where the transaction occurs a right to such funds, but it is an open issue as to whether this right actually exists. For instance, the U.S. Court of Appeals for the Third Circuit recently held that no such third priority rule existed in enjoining New Jersey's claim to unclaimed property arising from transactions occurring in New Jersey (*N.J. Retail Merchant's Assoc. v. Sidamon-Eristoff*, Case No. 10-4551 (3rd Cir. 1/5/2012)).

As you can see, acquiring assets of a company could be more than you bargained for if such assets include hidden unclaimed property. How can that happen? Well, what if accounts receivable of a company are purchased and there are negative balances present (i.e., overpayments)? Similarly, what if inventory is acquired and some of the inventory is under deposit, held on account, or possibly not fully paid for? In both instances, an asset is acquired that could have unclaimed property implications. Notably, these unclaimed property concerns also impact sellers of assets, since they too should understand what unclaimed property issues they are retaining or potentially transferring in an asset sale.

Obviously, becoming aware of the unclaimed property issue is the biggest step in solving any problems that can occur. This allows you to draft your asset sales agreement in a fashion to either avoid or at least address the concerns raised. The most important thing to remember is to tackle the unclaimed property issue right away in any due diligence undertaken, so you can understand the scope of the problem.

While ignorance is bliss, a buyer that simply ignores unclaimed property issues in an asset acquisition could end up paying a high cost for such ignorance years later when the reporting of such property becomes due.

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