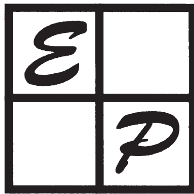
Try a 2013 No-Risk Trial Today!



DEAL LAWYERS

Vol. 7, No. 3 May-June 2013

Therapy for "Deal Fever": An Objective, Disciplined Due Diligence Process

By Mary Ann Cloyd, Leader, Center for Board Governance, PwC[1]

In this post-financial crisis environment, the mergers & acquisitions market is extremely competitive as both corporate and private equity investors have capital to invest but fewer quality deals in the marketplace to invest in. A competitive deal environment drives up bids and puts pressure on transaction timelines, increasing the potential for deal bias and conflicting interests.

These risks can be exacerbated when public companies are involved. Buyers may pay significant control premiums over the trading price of the stock but may have limited access to the information necessary to assess the deal strategy, risks, and value. The limitations imposed on receiving non-public information can arise from a variety of factors, including the dynamics of the sale process, regulatory considerations, and commercial sensitivity. Since there are virtually no contractual protections if something goes wrong in public deals, buyers are essentially taking the business "as is."

While audited financial statements are an important data point, their purpose is not to reveal revenue and earnings sustainability, or growth drivers, nor to forecast attainability, all of which are critical to assessing the baseline value of a business being acquired. Areas impacting risk and value, such as key customer or product revenue and margin trends, key performance indicators, manufacturing cost structure, systems, contract terms, and sales pipeline/backlog, may not be obvious or reportable under disclosure rules.

Investors looking to acquire control also need insight into forecasts that extend beyond public disclosures, and must assess synergies, management quality, and other areas of the business plan.

Bridging the Gap: Assessing Business Drivers & Synergies

In light of all of these factors, boards should take care in evaluating the due diligence findings and whether an objective, disciplined process was used. As part of their oversight, boards need to see that management can bridge the gap between the bid value and intrinsic value prior to announcing a deal. This entails an assessment of the business drivers for the transaction, underlying earnings and risks of the base business, synergies with the target company, and the current market economics. Ultimately, the

[1] ©2013 *PwC's* Center for Board Governance. This article first appeared in the February 2013 issue of "BoardroomDirect."

TABLE OF CONTENTS

– Therapy for "Deal Fever": An Objective, Disciplined Due Diligence Process 1
– Proposed DGCL Section 251 Amendments Should Lead to More Negotiated Tender Offers 3
– Setting the Record (Date) Straight 5
– How Today's Technology Simplifies the M&A Agreement Process 6
– Delaware: Reverse Triangular Mergers Don't Result in Assignment 8
– Economic Realism: Impact of Unvested Options on Purchase Price 11

© 2013 Executive Press, Inc.
DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com
ISSN 1944-7590

diligence findings should be incorporated into the deal model and significant information limitations or sensitivities should be highlighted in the decision process.

“Uncertainty is a certainty in any deal, but risk associated with the unknown has been amplified in the current economic environment,” said Aaron Gilcreast, a principal in PwC’s Deals practice. “As the economy recovers and companies chart a smart course for growth, deal makers will be well served by investing time and effort in valuation on the front end of transactions to avoid surprises on the back end.”

Valuation is just one part, albeit a very important one, of the acquisition process. Objective due diligence informs the valuation, where transparency as to what is known and what is not known is critical.

“Often one of the most revealing pieces of information is the one you wanted but did not get,” said Martyn Curragh, US Deals leader at PwC. The question is how has that been factored into management’s approach and assumptions, and is greater information needed to proceed.

“As a board, when you think about due diligence, you are asking, ‘What are the key strategic objectives of the transaction? What are the key assumptions driving our valuation model? How robust and expansive was our scope around these assumptions? What was it we set out to do that we didn’t do in diligence? Is there a 100-day plan?’” Curragh told directors attending a PwC 2012 Year-end considerations for audit committees seminar.

One director who has been involved in several M&A transactions said he remembers his boards taking a substantial amount of time considering the due diligence reports from management and advisors.

“It’s very significant,” said James Brady, who sits on the boards of McCormick & Co. and T. Rowe Price Group. “We’ve had audit firms and legal firms involved in the due diligence work. You have to do everything you can to see that there aren’t going to be any great surprises.”

As for the overall risks involving a deal, Brady looks at three areas: strategic rationale and return on investment, the due diligence process, and the integration plan. “We ask the CEO to tell us how the assumptions for this deal compare to assumptions in past deals,” he said.

Meanwhile, Brady and other directors like him are also cognizant of the possibility of deal bias, or “deal fever,” where the individuals most closely involved become enamored with the deal. If not checked, deal bias can drive up the price and affect management’s perception. This is a matter of human psychology, and it is always present; navigating this is key.

Curragh has seen this happen occasionally. “Sometimes valuations can get stretched when there’s strong competition for an asset and the banker says ‘the deal is yours if you can move your bid up to X,’” he said.

In the end, after due diligence is completed the board needs to become comfortable with management’s recommendation to do the transaction or walk away.

Checklist: Diligence Questions for Directors to Ask

Here are some questions boards may want to ask when considering an M&A transaction.

- Is there a clear understanding of the key strategic objectives of the transaction and alignment with the overall corporate strategy?
- To what extent does the company have a robust deal process?
- What has been the company’s historical performance in prior deals and what lessons have we learned?
- What are the company’s key criteria that must be met to get the deal approved?
- Have management and the board agreed on the level of communication and approvals the board expects during the deal process?
- What are the company’s minimum due diligence standards that must be met for a deal to be approved?
- What was the due diligence conducted regarding bribery compliance?

- How were the diligence findings incorporated into the valuation model, deal terms, and integration plan?
- What are the critical assumptions and how have these been built and challenged?
- What information or access did the company seek but not receive, and how were the resulting risks mitigated?
- Is there a cultural fit between the parties to the transaction?
- Is the board comfortable with the post deal integration plan and how will it monitor progress against the plan?

Proposed DGCL Section 251 Amendments Should Lead to More Negotiated Tender Offers

By Clifford Neimeth, Senior M&A Shareholder of Greenberg Traurig LLP

Recently, amendments to the Delaware General Corporation Law (DGCL) have been introduced by the Delaware State Bar Association (Section on Corporation Law) which, if adopted as proposed, should have a meaningful impact on, and lead to the increased use of, two-step public company acquisition structures (*i.e.*, acquisitions effected by means of a first-step tender offer followed by a second-step, or "back-end", merger). It is expected that these amendments will be signed into law by Governor Markell effective August 1, 2013.

The proposed amendments (which would apply purely on a permissive basis to target companies listed on a national securities exchange or whose voting stock is held by more than 2,000 holders) would add a new subsection (h) to Section 251 of the DGCL to permit the consummation of a second-step merger following completion of the front-end tender offer without the need to obtain stockholder approval of the merger, but only if certain structural and contractual conditions are satisfied. Accordingly, this would eliminate the need for the purchaser to convene a special stockholders' meeting and obtain stockholder approval for a long-form, second-step merger where the purchaser fails to acquire (whether directly in the initial tender offer period, as extended, or subsequently by means of exercising a "top-up" option or through the use of a Rule 14d-11 "subsequent offer period") the 90% or more of the target's outstanding voting stock necessary to complete a "short-form" merger under Section 253 of the DGCL.

Specifically, if new Section 251(h) of the DGCL is enacted as expected, the constituents to a negotiated merger agreement providing for a first-step tender offer could agree that stockholder approval of the back-end merger is not required, so long as:

(i) Merger agreement expressly states that the merger will be effected under Section 251(h) and that the merger will be completed promptly after consummation of the tender offer;

(ii) Purchaser commences and completes, in accordance with the terms of the merger agreement, an "any and all" tender offer for such number of outstanding target shares that otherwise would be entitled to vote to adopt the merger agreement (i.e., a majority of the outstanding shares or such higher percentage as may be required by the target's certificate of incorporation) and the purchaser, in fact, owns such requisite percentage of stock following consummation of the tender offer;

(iii) Consideration paid in the second-step merger for shares is the same (both in amount and type) as the consideration paid to tendering stockholders whose shares were accepted for payment and paid for in the front-end tender offer (excluding shares cancelled in the merger or qualifying for dissenters' rights);

(iv) following completion of the tender offer the purchaser, in fact, merges with the target; and

(v) At the time the target's directors approve the merger agreement, no party to the agreement is an "interested stockholder" (*i.e.*, a holder of 15% or more of the target's outstanding stock) within the meaning of Section 203 of the DGCL (*i.e.*, Delaware's three-year business combination/moratorium statute).

The proposed legislation reflects the recognition that, over the past decade, the use of top-up options to achieve the 90% ownership threshold for a short form merger under Section 253 of the DGCL has become de rigueur (except where the target lacks sufficient authorized and unissued capital stock "headroom" to effect the top-up grant and exercise). This is especially now the case in the wake of the *Olson v. EV3, Inc.*, *In re Cogent* and other recent decisions of the Delaware Court of Chancery which have validated the use of top-ups.[1]

Moreover, where the tender offer is completed and the purchaser becomes a majority parent of the target company, but is unable to effect a short-form merger because it does not own at least 90% of the target's stock, the need to prepare a merger proxy statement and convene a special stockholders' meeting at which stockholders vote to adopt the merger agreement, is a costly and often protracted formality, often allowing more time for strike-suit plaintiffs to attack the transaction terms, process and disclosure.[2]

Although merger agreements for two-step acquisitions require that, following consummation of the tender offer but prior to the effective time of the second-step merger, a formula-percentage of the target's directors (*i.e.*, those who are unaffiliated and not associated with the purchaser) must continue on the target's board as a "special committee" to enforce on behalf of minority stockholders the purchaser's compliance with the merger agreement, the stockholder vote on the merger is, nevertheless, a "done deal" because the parent will simply vote its shares "for" adoption.

Proposed Section 251(h) of the DGCL is an "optional" provision. If not elected to be used by the parties, the constituents to the merger agreement simply can continue to use top-up options (if available), "subsequent offer periods" under Rule 14d-11, so-called "dual track" tender offer/long-form merger structures used in several recent strategic acquisitions, and other methods that seek to expedite completion of the second-step merger to acquire the minority shares not tendered and obtain 100% voting and economic control of the target.

"Entire fairness" judicial review does not apply to a parent's squeeze-out merger effected pursuant to Section 253 of the DGCL. In contrast, the decision of target company directors to enter into a merger agreement that utilizes new Section 251(h) and to declare it "advisable" and recommend it for adoption, will remain subject to fulfillment of all relevant fiduciary duties (*i.e.*, care, loyalty and candor). Such duties will not be altered in any way by the enactment of the proposed amendments.

One inadvertent consequence of new Section 251(h) could be an increase in the percentage of tender offer "holdouts" (stockholder apathy) and/or an increase in stockholders seeking to perfect and exercise back-end merger appraisal rights under Section 262 of the DGCL. On the other hand, the enactment of new Section 251(h) should make permanent (non-bridge) financing of two-step acquisitions easier to obtain because of the increased assurance that the purchaser will acquire 100% economic and voting control of the target immediately following completion of the tender offer and gain direct access to all of the target's assets for collateral.

That said, because the satisfaction of a financing condition (including, under certain circumstances, the funding of a financing commitment) could necessitate an extension of the tender offer period (to the extent less than five business days remain before the stated expiration date), new Section 251(g) could

[1] For illustration, assuming that "Target Company A" has 50 million shares of common stock authorized for issuance under its certificate of incorporation and 25 million shares are issued and outstanding, at least 20 million (or 80% of the outstanding) shares would need to be tendered and accepted for payment in the tender offer for a top-up option to work. Thus, if 20 million shares (exactly) were tendered and purchased, the grant and exercise of a top-up option to purchase all of the additional 25 million shares available for issuance would result in the purchaser owning 45 million, or 90%, of the (now) 50 million total shares outstanding, and (assuming there is no other class or series of stock outstanding having the right to vote on a merger) the purchaser can consummate a short-form (second-step) merger under Section 253 of the DGCL. Accordingly, top-up options are effective only when the target has a significant new share issuance cushion and the holders of a substantial percentage of the outstanding shares participate in the tender offer.

[2] On the other hand, if the tender offer period is extended a few times in order to satisfy regulatory or other conditions (*i.e.*, to the extent permitted by the merger agreement) there will be a window of opportunity for opportunistic plaintiffs and, potentially, for "topping" (competing) bidders and "deal jumpers"

result in changes to the traditional structure, terms and timing of funding of financing commitment letters and the use (and even phraseology) of certain tender offer financing conditions. This likely would have more impact on non-strategic buyers (in large cap deals) who rely more on external debt financing (in addition to limited partner capital commitments and management equity rollovers) and who may need to expedite the marketing and sale of debt securities to help fund the acquisition. As with any new legislation, the benefits and consequences thereof will evolve and, therefore, may not be 100% apparent until after enactment.

Overall, this is a very positive and significant legislative development (much like the adoption of Regulation M-A in 2000 and the SEC's amendment and clarification of the "all-holders/best-price" rules in 2006). The enactment of new Section 251(h) of the DGCL should lead to an increase in the use of the tender offer structure for negotiated mergers and acquisitions of Delaware public companies. By eliminating the purchaser's need to conduct a long-form, second-step merger to take out minority stockholders who did not participate in the front-end tender offer (where "top-up" options, Rule 14d-11 "subsequent offer periods" and other methods to achieve 90% ownership either are unavailable or do not mathematically work), 100% voting and economic control can be purchased and sold quickly, which is in the best interests of the target's stockholders and all constituent parties to the merger agreement.

Setting the Record (Date) Straight

By Daniel Wolf, Jeffrey Symons, Joshua Zachariah and David Feirstein of Kirkland & Ellis LLP

A record date, often viewed in the merger context as a mere mechanic to be quickly checked off a "to do" list, creates a frozen list of stockholders as of a specified date who are entitled to receive notice of, and to vote at, a stockholders' meeting. A tactical approach to the timing of the record date can have strategic implications on the prospects for a deal's success, while the failure to comply with the rules relating to setting a record date could cause a significant delay in holding the vote, leaving the door open for a topping bidder or dissident stockholder to emerge or gather support. As a result, it is important that dealmakers understand the basic mechanics and rules of setting a record date and the tactical repercussions of the record date construct.

Starting first with the legal requirements, there are several key inputs that inform the mechanics of setting a record date, including laws of the company's state of incorporation, the company's organizational documents, federal securities laws, rules of the applicable securities exchange and the relevant merger agreement. Taken together, these requirements dictate the necessary procedural and governance steps for setting the record date and establish the minimum and maximum time periods between the record date and the meeting, as well as between the board action setting the record date and the record date itself.

The perils of failing to comply with formalistic legal requirements were highlighted in the Staples decision in 2004. Then VC Strine, in a fact-intensive decision, enjoined the impending vote and required Staples to fix a new record date before proceeding with its meeting because he found that the power to set the record date had not been properly delegated by the board and contemporaneous documentation of the action setting the record date was absent. Similarly, failure to comply with the federal SEC broker-search requirements in a timely manner for the requisite period ahead of the record date can have unforeseen consequences. In a number of cases, particularly where the deal is being contested, the SEC has commented on the failure to comply with these rules, resulting in a potential requirement to establish a new record date and postponement of the vote (see, e.g., Midwest/AirTran, Dollar Thrifty/Hertz).

Beyond the technical requirements, there are also strategically significant considerations in setting the record date because of its role in determining which stockholders are entitled to vote. On the most basic level, locking in the stockholder list provides the company and its advisers with a settled group of stockholders from whom they can solicit votes. More broadly, an early freezing of the voter base can impede dissident stockholders or competing bidders from buying in (or further buying in) after the record date and thereby seeking to influence the outcome of the vote because, as a general matter, the right to

vote does not transfer with shares acquired after the record date. On the flip side, an early record date can exacerbate the risk of "empty voting" where stockholders who have sold their shares after the record date but before the meeting continue to have the right to vote for or against a deal despite lacking a corresponding economic interest in the company.

Motivated in part by a perceived need to address the potential mischief that can result from "empty voting", in 2009 Delaware adopted amendments to the DGCL allowing companies to bifurcate their record dates, setting one earlier record date for notice of the meeting and a later record date for the right to vote. While a later voting record date may alleviate the empty voting issue (or at least shorten the exposure period), the benefit might be outweighed by offsetting considerations. For example, the ability to solicit votes may be partially impaired because of the failure to get an early and fixed snapshot of the stockholder base and setting a bifurcated record date may (rightly or wrongly) signal to the market that the company is concerned about its ability to obtain the requisite vote.

The potential strategic implications of setting a record date become apparent when the record date has ramifications on the ability to delay a scheduled meeting. The need or desire to delay a meeting can arise in a number of different circumstances, e.g., where a competing bid or other new information surfaces close to the scheduled meeting date or where the company has concerns about obtaining the required vote. As seen in the maneuvering over the delays in the stockholder votes in Dynegy and Cedar Fair in 2010, the ability of a company to delay the stockholder vote in the face of opposition to the proposed merger is significantly impacted by the effect of the delay on the existing record date as well as somewhat intricate legal distinctions under state law and the company's organizational documents.

While producing the same outcome in terms of delaying the scheduled vote, the mechanism of delay—i.e., whether termed a postponement, adjournment or recess—may be a key determinative for the delay resulting in the need to set a new record date (and therefore a refreshed list of stockholders entitled to vote on the deal) and whether stockholder approval for the delay itself may be required. Parties should also be mindful that courts may critically review a decision to delay a meeting (and to preserve or, alternatively, update the record date) if the court determines that the intent of the delay and its impact on the record date, by postponement, adjournment or otherwise, was to frustrate the stockholder franchise or was an improper defensive tactic.

The inevitably unique facts of each deal will likely dictate the optimal record date for the stockholder meeting. Early attention to the record date question is advisable given the long lead-time under some of the procedural legal requirements mentioned above. Compliance with technical requirements and an awareness of strategic implications are necessary to ensure that parties don't fall prey to pitfalls inherent in treating setting the record date as a mere administrative task.

How Today's Technology Simplifies the M&A Agreement Process

By Suzanne Petren Moritz, VP & Managing Director of Lexis Practice Advisor

Q: How can technology assist M&A attorneys with their daily workload?

A: LexisNexis recently launched an online practical guidance product for M&A attorneys, as part of our Lexis Practice Advisor offering. It combines guidance from leading practitioners with model forms and templates, covering each step an M&A practitioner needs to take during a transaction or filing, from deal evaluation and due diligence through to document drafting.

In addition, the M&A offering features a new deal analysis tool, Lexis Market Tracker that provides unique insights on current market trends.

Q: Specifically, what are the steps in an M&A process that the tool supports?

A: Lexis Practice Advisor is organized by M&A deal type and covers a transaction from the beginning to the end. For example, in the public mergers and acquisition area, we cover everything from structuring and planning a deal, through to drafting the executive and ancillary documents and the closing of the transaction.

We address three key pain points of M&A attorneys: First, we help them simplify the routine aspects of their work by putting all information and insights related to the specific transaction right at their fingertips—from practical guidance and practice notes, to forms with annotations, through to the supporting cases and legislative materials.

Second, in order to help them stay current or get up to speed quickly on new matters, we furnish them with the most up-to-date content and commentary provided by attorneys from top law firms.

Third, our forms section offers leading checklists, templates and interactive documents that are an ideal starting point for drafting.

Q: How do you use the forms and templates?

A: In the forms section, you can find a variety of forms, templates and checklists that make for an ideal starting point for drafting. Say you wanted to draft an asset purchase agreement. You have the option to start out with a pro-buyer or a pro-seller base document, which you may then tailor to your needs by inserting alternate clauses and suggested language while drawing on commentary on specific provisions by leading experts. All our expert form documents come with practice notes as well as with alternative clauses. The forms are interactive and can be filled out online or downloaded in Word, saved to a work folder or emailed to colleagues.

Q: How does one find out what is "market"?

A: Traditionally, M&A attorneys had to rely on archived agreements from their firm libraries to get a general sense of how their peers and competitors were structuring and planning deals. Today, attorneys have internal databases with their firm's collection of documents at their disposal as well as external sources such as EDGAR. Yet, they are still required to sift through stacks of electronic documents to pinpoint the most relevant deals and the associated documents. Then they have to read through hundreds of pages to find the precise deal provisions and language that are most pertinent—all without knowing with certainty that they have indeed looked at a wide or recent enough sample.

This is why we're including Lexis Market Tracker. It scours the full universe of recent deals within a matter of seconds. What's more, the tool is very granular, allowing you to drill deeper into over 500 deal points—from no-shop provisions to the precise language of transaction conditions—and it collects and tags all the relevant documents, putting the precise language, terms or clauses you are looking to compare right at your fingertips.

Q: Let's drill down for an example. How would one find out the median break-up fee for a deal in the healthcare industry?

A: It's quite easy. You would simply choose the deal type—merger—and the industry—healthcare. In the drop-down menu, you can expand the "termination terms" section, choose "termination fees" and then run your search. It will populate a grid in the right hand pane that provides the specific language related to termination fees within each of the deal agreements and the amount of the fee.

You can then analyze this further by clicking on the analytic icon which will bring up a box that shows the minimum, maximum, median and mean across all deals.

Q: Another example—what about researching deals worked on by a particular law firm?

A: That's right on the main menu. You simply type in the firm name and you will see all deals the firm has worked on. You may look at what they've done on the seller or buyer side, and which individual attorneys were involved. From there, you can drill down on any particular provision such as closing conditions, indemnification or no-shops to see what language the law firm has accepted in the past. All this populates in an easy-to-navigate spreadsheet.

Delaware: Reverse Triangular Mergers Don't Result in Assignment

By Phil Stamatakos and Ismail Alsheik of Jones Day[1]

The Delaware Chancery Court recently published an important decision that holds that reverse triangular mergers do not result in the assignment of a target corporation's contracts by operation of law. The decision clarified a 2011 ruling in the same case, *Meso Scale Diagnostics v. Roche Diagnostics GmbH* ("Meso 2011"),[2] in which the court refused to arrive at that conclusion. Meso 2011 left acquirers uncertain about whether structuring transactions as reverse triangular mergers would give contract counterparties the right to terminate their contracts with acquisition targets under anti-assignment provisions. The new decision ("Meso 2013") provides comfort to corporations that have long structured acquisitions and reorganizations as reverse triangular mergers, in part, to avoid triggering such termination rights.

Reverse Triangular Mergers

In a reverse triangular merger or "RTM," an acquirer forms an acquisition subsidiary that merges with a target corporation, the target's stockholders receive merger consideration and the target survives the merger and becomes a wholly-owned subsidiary of the acquirer. Acquisitions are often structured as RTMs when a target has such a large number of stockholders that it would be impractical or too time consuming to obtain their signatures on a purchase agreement, and it is anticipated that the number of shares held by a target's stockholders who would vote in favor of a merger is more than 50% of the target's outstanding stock, the default percentage required to adopt a RTM under Delaware's and many states' laws.

RTMs are also employed when a target is a party to one or more material contracts that contain anti-assignment provisions and the acquirer wishes to avoid consummating an acquisition using a structure such as an asset purchase or forward triangular merger that could provide the counterparty with a basis for terminating those contracts under such provisions. In either case, a significant benefit of RTMs is that they eliminate or reduce the risk that termination rights will be invoked by contract counterparties.

The Meso Decisions

In 2003, Meso Scale Diagnostics entered into a non-exclusive intellectual property license pursuant to which it licensed technology to BioVeris Corp. A subsequent agreement between the parties prohibited the assignment of the intellectual property by BioVeris Corp. "by operation of law or otherwise."[3] In 2007, Roche acquired BioVeris Corp. for $1.25 billion by way of a RTM with BioVeris Corp. surviving the merger and becoming a wholly-owned subsidiary of Roche.

In Meso 2011, which involved a motion to dismiss, Meso claimed that BioVeris Corp.'s RTM with the Roche subsidiary constituted an assignment by operation of law entitling Meso to terminate the license. To support its position, it asserted that RTMs are akin to forward triangular mergers in which a target corporation is merged with and into an acquirer's merger subsidiary with the merger subsidiary surviving the merger. Meso also pointed to an unpublished federal court case, *SQL Solutions*,[4] which applied California law and held that RTMs result in assignments by operation of law. Roche argued that RTMs are distinguishable from forward triangular mergers (in which the target ceases to exist) and are akin to stock purchases in which the owners' interests changes, but the target's contractual and other legal relationships remain unaltered.

When considering a motion to dismiss, a Delaware court must determine whether a complaint offers sufficient facts to plausibly suggest that the plaintiff is entitled to relief. In Meso 2011, the court concluded that, because Delaware had not considered whether RTMs involve the assignment of assets by operation of law, it was unable to dismiss the case in Roche's favor. Consequently, the case left open the possibility that RTMs result in assignments of a target's contracts by operation of law and during the period between Meso 2011 and Meso 2013, practitioners were unable to provide their clients with definitive

[1] Philip Stamatakos is a partner and Ismail Alsheik is an associate in the Mergers & Acquisitions group of Jones Day.

[2] *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, 62 A.3d 62 (Del. Ch. Feb. 22, 2013).

[3] *Id.* at 65.

[4] *SQL Solutions, Inc. v. Oracle Corp.*, 1991 WL 626458 at 4 (N.D. Cal. Dec. 18, 1991).

advice about whether RTMs under Delaware law would permit contract counterparties to terminate certain contracts with a target.

Meso 2013 involved a motion for summary judgment and the court ruled for Roche. Meso contended that RTMs result in an acquisition target assigning its assets to the surviving entity. The court disagreed. The court stated that, "[g]enerally, mergers do not result in an assignment by operation of law of assets that began as property of the surviving entity and continued to be such after the merger."[5] In support of its position, the court cited Section 259(a) of Delaware's General Corporation Law which sets forth the consequences of a RTM for the constituent corporations. The court observed that, under Section 259(a), a RTM results in the transfer of the non-surviving corporation's rights and obligations to the surviving corporation by operation of law, but does not constitute an assignment by operation of law as to the surviving entity because that entity is the same legal entity as the original contracting party.

Moreover, the court noted that Roche's interpretation of the anti-assignment provision was consistent with the reasonable expectations of the parties, given that the "vast majority of commentary discussing reverse triangular mergers indicates that a reverse triangular merger does not constitute an assignment by operation of law as to [even] the nonsurviving entity."[6] Meso also argued that a RTM results in a target corporation changing its corporate form and that a change of corporate form results in an assignment. Again, the court disagreed and concluded that a RTM does not change an acquisition target's corporate form in the way that a LLC's form is changed when it is converted into a corporation. Finally, the court refused to adopt the approach of the federal district court in SQL Solutions. Instead, the court analogized what happens in a RTM to what happens in a stock purchase where the purchase of securities results in a change of ownership of the securities, but is not regarded as assigning or delegating the contractual rights or duties of the corporation whose securities are purchased.

Implications

Meso 2013 effectively provides a bright-line rule for determining the effect of certain acquisition structures on the assignment of contractual rights under Delaware law: RTMs and stock purchases will not result in the assignment by operation of law of a target corporation's contracts. Thus, the case reaffirms that, in Delaware, RTMs may be employed by contracting parties to avoid triggering anti-assignment provisions in targets' contracts. This is not the case in all states, however.

1. *The "California" Approach*

SQL Solutions is part of a line of California cases recognizing that "an assignment or transfer of rights does occur through a change in the legal form of ownership of a business."[7] As such, practitioners typically treat the question of whether a RTM in California triggers an anti-assignment provision as settled.[8] At least one court has favorably cited *SQL Solutions*, finding that a RTM results in an assignment by operation of law. In *DBA Distribution*,[9] a federal court held that a RTM constitutes an assignment by operation of law under New Jersey law, citing the New Jersey merger statute, which, the court noted, "provides that the property belonging to each of the constituent corporations 'shall be vested' in the surviving or new corporation." The court also cited *SQL Solutions* for the proposition that, "when a company becomes a

[5] *Meso Scale Diagnostics, LLC*, 62 A.3d 62, at 82.

[6] *Id*. at 83.

[7] Among other cases, the court cited *Trubowitch v. Riverbank Canning Co.*, where the court held that if an assignment results merely from a change in the legal form of ownership of a business, its validity depends upon whether it affects the interests of the parties protected by the nonassignability of the contract. 30 Cal.2d 335, 344–45 (1947); see also, *People ex rel. Dep't of Pub. Works v. McNamara Corp. Ltd.*, 28 Cal.App.3d 641, 648 (1972).

[8] In the authors' view, for several reasons, a California state court considering facts akin to *Meso* could reach a different result than the court in *SQL Solutions*. First, *SQL Solutions* is a California federal district court decision, so it is only persuasive authority in California courts, which have not yet ruled definitively on the issue. Second, a number of commentators have called into question the holding in *SQL Solutions*. Finally, in arriving at its conclusion, *SQL Solutions* court relied on cases in which a RTM had not occurred. For instance, in *Trubowitch*, 30 Cal.2d 335, 337 (1947), the contract in question was assigned in connection with the dissolution of a corporation that was a counterparty to the contract.

[9] *DBA Distribution Services, Inc. v. All Source Freight Solutions, Inc.*, 2012 WL 845929 at 4 (D.N.J. Mar. 13, 2012).

wholly-owned subsidiary, a fundamental change in its form of ownership occurs."[10] The court held that "[t]he act of merger therefore caused the transfer of the Agreement by operation of law."[11]

Because *DBA Distribution* is a New Jersey federal district court decision, it is only persuasive authority in New Jersey courts, which have not yet ruled definitively on the issue. It remains to be seen whether favorable citation of *SQL Solutions* was a one-off event or will ultimately gain traction in other state courts.

2. *The Statutory Approach*

A number of states, including Iowa, Kentucky, Massachusetts and Michigan have substantially implemented the 1984 version of the ABA Model Business Corporation Act (the "1984 Model Act"), which states that "the title to all real estate and other property and rights owned by each corporation party to the merger are vested in the surviving corporation without reversion or impairment"[12] and which includes a comment that "[a] merger is not a conveyance, transfer or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance, transfer or assignment. It does not give rise to a claim that a contract with a party to the merger is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive a merger."[13]

It can generally be assumed that RTMs do not constitute an assignment in states that have passed some version of the 1984 Model Act, though specific state statutes should be reviewed when determining their affect in connection with particular transactions because states often adopt model acts with modifications. Colorado has gone a step further than the 1984 Model Act and has adopted a merger statute that states that, "[a] merger does not constitute a conveyance, transfer, or assignment. Nothing in this section affects the validity of contract provisions or of reversions or other forms of title limitations that attach conditions or consequences specifically to mergers."[14]

Some states, such as Alabama and Illinois, have promulgated merger statutes that include language or variations of language from the 1969 version of the ABA Model Business Corporation Act (the "1969 Model Act"). The 1969 Model Act is ambiguous about whether a merger constitutes an assignment of an agreement by operation of law and states that, in connection with a merger, the assets of each constituent entity "shall be taken and deemed to be transferred to and vested in such single corporation without further act or deed."[15] It is unclear whether RTMs and forward triangular mergers would be treated similarly under such statutes despite their fundamental differences. There have been some anomalous decisions in states with such statutes. Alabama's merger statute, for instance, includes such language, but at least one appellate court there has ruled that a merger does not constitute a transfer or assignment by operation of law.[16]

The Bottom Line

Meso 2013 establishes that RTMs are not assignments by operation of law in Delaware. Therefore, where, as in *Meso*, Delaware law governs both a RTM and a contract containing an anti-assignment provision that permits a counterparty to terminate if there has been an assignment by operation of law, companies can be confident that there is no risk of contract counterparty termination.

We are not aware of cases in any state that have addressed which law controls when a RTM is governed by the laws of one state and an underlying contract is governed by the law of a different state and the two laws arrive at contrary conclusions about whether the RTM constitutes an assignment by operation of law. In such cases and where federal intellectual property law applies to a contract, a contract coun-

[10] *Id.*

[11] *Id.*

[12] Mod. Bus. Corp. Act Ann. § 11.07(a)(3) (1984).

[13] *Id.*, Comment to § 11.07.

[14] C.R.S.A. § 7-90-204.

[15] Mod. Bus. Corp. Act Ann. § 76(d) (1969).

[16] *Int'l Paper Co. v. Broadhead*, 662 So.2d 277, 279 (Ala. Civ. App. 1995).

terparty could argue that the applicable law is that which would deem an assignment to have occurred upon the consummation of the RTM.

In those cases, in jurisdictions such as California in which RTMs constitute assignments by operation of law and when a RTM or a contract is governed by the law of one of the many jurisdictions that have not addressed the issue of whether a RTM constitutes an assignment by operation of law, acquirers should consider whether to obtain consents from contract counterparties as a condition to closing or structure their transactions as tender offers or stock purchases, forms of transactions that typically do not trigger contract counterparty termination rights.

Finally, *Meso 2013* should serve as a reminder that anti-assignment provisions in commercial contracts should be drafted precisely to reflect the parties' intentions with respect to the consequences of RTMs and forward triangular mergers on parties' rights under such contracts.

Economic Realism: Impact of Unvested Options on Purchase Price

By Lior Zorea, a Partner of Perkins Coie LLP

"Do you want a good price or good terms? Pick one, but not both." A merger transaction typically involves this choice; however, buyers and sellers frequently focus on price when hidden value or hidden costs are buried in the deal terms.

One term that can have a significant impact on the deal value is the treatment of the target's unvested options. Vested options can be assumed by the acquirer or, more typically, paid out for their in-the-money value. Unvested options can be treated in a variety of ways (the target's option plan typically provides the legal framework for the treatment of unvested options in a merger transaction). Some plans provide that any unvested options are cancelled at the closing of the merger transaction, some plans provide for full acceleration of vesting in connection with the merger and, as is most common, some plans provide that vesting will be fully accelerated if the options are not assumed by the acquirer. Each one of these alternatives should be reviewed carefully in terms of the potential impact to the deal and the purchase price.

Cancelling unvested options removes them from the cap table, eliminating their impact on the purchase price. However, option plans that call for cancelling options in a merger can create discord among the target's employees holding unvested options, who may feel that the merger transaction distorted their pre-transaction compensation arrangement. This can have a jarring effect on the morale of the target's employee base, particularly the target's most recent hires, who tend to have the largest proportion of unvested options. Furthermore, the prospect of cancellation can result in instability among the target's employee base, making it difficult for the target to retain employees during the pendency of a transaction or following the termination of a failed merger transaction. Similarly, a potential acquirer will want to flag this provision in an option plan since it has real repercussions for the acquirer's ability to retain the target's employee base following the merger in the absence of significant post-close retention mechanisms. To the extent that the acquirer grants new options to retain the target's employees, those new options dilute the acquirer's existing shareholding base, thereby effectively increasing the "cost" of the transaction.

The flip side of cancellation, full acceleration of unvested options, also has real costs for the target and the acquirer. Full acceleration effectively transfers deal consideration from the target's stockholders to employees who arguably haven't "earned it" by satisfying the employment vesting requirements for their option grants (and who hasn't heard a story about a receptionist at a startup becoming a millionaire overnight after working for only a few months before the company was acquired?). This also has real costs for the acquirer, because as in the situation where the options are cancelled, the acquirer may need to

provide significant post-close retention mechanisms to the target's employees. This often has additional hidden costs for the acquirer, whose existing employees perceive the target's employees as getting a sweetheart deal at their expense.

Unvested options can also be assumed by the acquirer. There are two potential scenarios. The acquirer can assume the unvested options and convert them to unvested options of the acquirer, which would come out of the acquirer's option or restricted stock pool. Sometimes the acquirer will view these options as a post-close retention cost and will assume the unvested options in addition to the negotiated purchase price. Acquirers are leery of treating the unvested options in this manner because in many cases, in anticipation of an acquisition, targets tend to make option grants that are outside the ordinary course. This is particularly the case in circumstances where the acquirer may have a different view on the appropriate amount of post-closing retention, whether on an aggregate or individual level basis.

More often than not, the acquirer will take the position that assuming or substituting consideration for the unvested options is part of the deal consideration. In this case, the acquirer has effectively shifted a portion of the purchase price to a post-closing retention mechanism, which arguably should be understood between the parties as a separate post-closing cost of the acquirer.

In addition to assuming unvested options, acquirers can recast standard retention mechanisms as deal consideration. These can include, among others: retention bonuses, stock grants, above-market salaries and earn-outs. While we fully expect transactions to be structured with significant back-end "goodies" to successfully transfer the goodwill of the business to the acquirer, we would suggest that the parties be clear on the real economics. In other words, the parties should be clear on the portion of the purchase price that reflects payment for the existing business (i.e., solely for the benefit of the target's equity holders) and the portion of the purchase price that could be more accurately characterized as post-closing retention cost (some of which may be for the benefit of the target's equity holders, some of which may be for the benefit of the target's continuing employees and some of which may ultimately revert back to the acquirer).

Finally, in many deals, the top-line purchase price, rather than the actual consideration to the target's equity holders, is the number used to calculate other deal terms such as indemnification limits, escrow amounts (and related deductibles, baskets, etc.), management carve-out amounts and potential retention arrangements. Again, the greater the clarity on the real economics, the less likely it is that these economic terms are skewed in favor of the acquirer or the target. For example, if the deal consideration is $100 with $10 of value allocated to unvested options, should a typical 15% escrow be $15 (*i.e.*, 15% * $100) or $13.50 (*i.e.*, 15% * $90)?

Happy negotiations . . .

Our Pair of Popular Executive Pay Conferences: A 15% Early Bird Discount: On CompensationStandards.com, we have posted the registration information for our popular conferences - "Tackling Your 2014 Compensation Disclosures: The Proxy Disclosure Conference" & "Say-on-Pay Workshop: 10th Annual Executive Compensation Conference" - to be held September 23-24th in Washington DC and via Live Nationwide Video Webcast.

Early Bird Rates - Act by May 31st: Huge changes are afoot for executive compensation practices and the related disclosures. We are doing our part to help you address all these changes - and avoid costly pitfalls - by offering a special early bird discount rate. So register by May 31st to take advantage of the 15% discount.

A sister publication of the popular newsletter, *The Corporate Counsel*, *Deal Lawyers* is a bi-monthly newsletter for M&A practitioners to keep them abreast of the latest developments and analyze deal practices.

Publisher: **Jesse M. Brill.** Formerly an attorney with the Securities and Exchange Commission and a leading authority on executive compensation practices, Mr. Brill is the Publisher/Editor of *The Corporate Counsel*, Chair of the National Association of Stock Plan Professionals, CompensationStandards.com and DealLawyers.com.

Editor: **Broc Romanek**, former SEC attorney and Editor of DealLawyers.com and TheCorporateCounsel.net. Broc can be reached at broc@naspp.com.

DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com