Five Day Tender Offers: What Can Market Participants Expect?

By James Moloney, Glenn Pollner and Cem Surmeli of Gibson, Dunn & Crutcher LLP

Following the issuance of a no-action letter, dated January 23, 2015 (the “No-Action Letter”), by the Division of Corporation Finance (the “Staff”) of the Securities and Exchange Commission (the “SEC”), issuers, and their parent entities and wholly-owned subsidiaries, are now permitted to conduct five business day tender offers for any and all of their non-convertible debt securities so long as certain conditions are met (“Five Day Tender Offers”). Such conditions include requirements that the offer is: (i) announced via press release through a widely disseminated news or wire service (“Immediate Widespread Dissemination”); (i) not made in connection with a solicitation of consents to amend any of the agreements governing the subject securities; and (iii) open to all record and beneficial holders of the subject securities (except with respect to exchange offers where Qualified Debt Securities (as defined in the No-Action Letter) are offered solely to Qualified Institutional Buyers (“QIBs”) and non-U.S. persons (together with QIBs, “Eligible Exchange Offer Participants”).

The advent of the Five Day Tender Offer is likely to have significant implications for participants in the debt markets, including issuers, dealer-managers and institutional investors, and potentially signals broader regulatory shifts that may impact tender offers on a larger scale. Although the full scope and breadth of these implications are not entirely clear, as the use of the Five Day Tender Offer potentially becomes widespread, the following implications and considerations may emerge and become more relevant to market participants.

1 © 2015 Gibson, Dunn & Crutcher LLP. James J. Moloney is Co-Chair of Gibson, Dunn & Crutcher LLP’s Securities Regulation and Corporate Governance Practice Group and is a Corporate Partner in the firm’s Orange County office. Glenn Pollner is a Corporate Partner in Gibson Dunn’s New York office. Cem Surmeli is a Corporate Associate in Gibson Dunn’s Orange County office.


3 As defined in Rule 144A under the Securities Act of 1933, as amended (the “Securities Act”).

4 See id.; see also James Moloney, Sean Sullivan and Todd Trattner, Five Day Tender Offers: Conditions and Timelines, in this March/April 2015 issue of Deal Lawyers (discussing each of the conditions that must be satisfied in order to conduct Five Day Tender Offers).

5 The first issuer to conduct a Five Day Tender Offer appears to be Waste Management, Inc. See Waste Management Announces Cash Tender Offer (Feb 18, 2015), http://investors.wm.com/phoenix.zhtml?c=119743&p=irol-recentnewsArticle&ID=2017702.

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Implications for Issuers

Issuers conducting Five Day Tender Offers will need to reexamine the mechanics for their tender offers, as well as the substantive disclosures contained in their tender offer materials, in order to optimize the results of an offer conducted during the short time period. In particular, issuers may emphasize drafting shorter disclosures that are easier for holders of debt securities to read and comprehend in the short time span available. With respect to mechanics, Five Day Tender Offers will afford issuers significantly less time to communicate with and receive a response from holders, as compared to a 20-business day tender offer period. Issuers will need to work closely with their dealer-managers and legal and financial advisors to ensure that the offering documentation is finalized prior to 10 a.m. (Eastern time) on the date of commencement, and all eligible holders receive the tender offer materials with sufficient time to consider the offer and decide whether or not to tender their securities. Accordingly, issuers will want to work with their trustees to maintain a complete and accurate list of the email addresses of the holders of their debt securities.

While the initial cost and burden associated with dissemination will be lessened by the elimination of hard copy distributions and mailings, the shift to public and immediate dissemination (e.g., via email, press release and 8-K filing, when the issuer is a public reporting company) will mean that the press, analysts, rating agencies and institutional investor services will have greater access to the tender documents. As a result, issuers can expect to receive increased attention and publicity with respect to their debt tender offers. Some of this attention may be beneficial, resulting in higher tender participation rates. At the same time, it could lead to increased scrutiny from other stakeholders, such as holders of debt securities that are not sought in the tender offer, equity holders, analysts, financial media and perhaps even regulators such as the SEC.

In addition to these practical considerations, issuers, working with their legal and financial advisors, will need to consider how best to structure and time their Five Day Tender Offers given the restriction on simultaneous consent solicitations. The inability to solicit consents will likely prevent many issuers from stripping out covenants present in a related indenture, a practice particularly common in connection with tender offers for high yield debt. This limitation, however, should not pose a significant burden for issuers with debt securities that were initially rated investment grade when issued but have since been downgraded—so-called “fallen angels”—because the related indentures would not contain as many potentially problematic covenants. It is possible, however, that issuers with covenants in their indentures requiring attention may seek to impose relatively high minimum tender conditions in their offers to minimize the potential for defaults or cross-defaults in any bonds not tendered in the tender offer and that remain outstanding. In doing so, issuers may be able to minimize the number of bonds that remain outstanding following consummation of the offer to the point at which either the remaining stub is immaterial or the bonds can be acquired by means of a redemption pursuant to the relevant indenture terms, open market purchase or other acquisition method or satisfied and discharged and/or defeased under the relevant indenture terms. Furthermore, issuers may strategically choose the timing of their offers to minimize market risks and avoid weekends and federal holidays to maximize participation rates.

With respect to exchange offers, there will be other matters for issuers to consider. For example, while the No-Action Letter contemplates the ability to make a “private” offering of Qualified Debt Securities to investors who are QIBs or non-U.S. persons, it also requires Immediate Widespread Dissemination of the tender offer materials. As a result, an issuer may be viewed as engaging in a “general solicitation” when it sends emails and issues press releases announcing the tender offer, which would necessitate reliance on a private offering exemption that permits general solicitation. However, there may be ways in which an issuer can structure its public disclosures in order to minimize the likelihood that its communications could be deemed a general solicitation. One such approach would be for the initial offering communication to consist solely of a simple notice of transaction with directions to a secure website established by the issuer where an investor would have to “click through” and certify its QIB or non-U.S. person status in order to receive the full offer materials; any investor unable to certify to such status would be directed to a separate page with information on the cash election option afforded to such holders (as discussed more fully herein). But regardless of whether such communications rise to the level of a general solicitation, issuers contemplating exchange offers will want to carefully consider the available exemptions from registration under the U.S. securities laws. For example:

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The foregoing exemptions should be evaluated fully in the context of a Five Day Tender Offer. For example, Rule 506(c) permits offers to be made to accredited investors, which includes a broader range of investors relative to QIBs. However, given that the No-Action Letter limits an issuer’s ability to offer Qualified Debt Securities to QIBs and non-U.S. persons under Regulation S, the added category of “accredited investor” offerees under Rule 506(c) may provide little incremental benefit, while giving rise to additional compliance burdens.

Implications for Dealer-Managers / Financial Advisors

Based on the requirements outlined in the No-Action Letter, the role of dealer-managers is likely to evolve in the context of a Five Day Tender Offer. Whereas dealer-managers previously played a significant role in the tender offer process by ensuring full dissemination of tender offer materials to holders of debt securities at the commencement of the offer, the Immediate Widespread Dissemination requirement will render this function less prominent. Instead, the dealer-managers’ role in determining the structure and economic terms of the offer, evaluating appropriate tender conditions, assisting with financing and engaging in follow-up communications with, and providing information to, holders following the initial distribution of tender offer materials will become more critical.

In addition, it may be advantageous for issuers to use dealer-managers to perform some limited “testing the waters” prior to commencing a debt tender offer. Given the relatively short time span involved,
existing holders may be open to signing confidentiality agreements with a limited duration and may even be willing to sign lock-ups (albeit subject to specified conditions) in advance that would provide issuers with greater certainty on the acceptability of the offer terms to a sufficient number of holders. In doing so, issuers could disclose in their offer materials that holders with a specified percentage of the subject securities have agreed to tender the securities in the offer. Negotiating such lock-ups in advance should make it more likely that the offer is ultimately successful.

Moreover, given the short time frame for conducting tender and exchange offers pursuant to the No-Action Letter, any diligence on the issuer and/or guarantors would need to be conducted in advance. It is possible that some issuers will have their financial advisors perform such diligence early on, so that they are in a position to launch a tender or exchange offer on relatively short notice. This new-found flexibility should allow issuers to benefit from any windows of opportunity that may arise when low interest rates or other favorable market conditions prevail, provided they have prepared for the refinancing event in advance.

Implications for Holders of Debt Securities

The most obvious difference for holders of debt securities in a Five Day Tender Offer is that they will have significantly less time to evaluate the terms of an offer relative to a 20-business day tender offer. Combined with the shift to electronic dissemination of the offer materials, a holder may wish to take steps to see that it does not miss a tender offer entirely or learn about it too late in the process to make a fully informed investment decision. In order to reduce this risk, holders should sign up for corporate action lists that issuers will use to electronically distribute press releases related to the offer, and carefully monitor electronic communications coming from issuers where they have an investment in debt securities. Holders should also review press and analyst coverage dedicated to the offer. The Immediate Widespread Dissemination of the offer materials should encourage both the press and analyst community to pay greater attention to Five Day Tender Offers, and their coverage may provide investors with more helpful information and insight vis-à-vis traditional debt tender offers, in which only the most basic terms are summarized in a press release.

Implications for the Broader Regulatory Scheme

The issuance of the No-Action Letter also raises some important questions regarding the U.S. regulatory scheme applicable to tender offers, as well as factors that bear on the particularities of Five Day Tender Offers.

Dissemination of the offer materials should encourage both the press and analyst community to pay greater attention to Five Day Tender Offers, and their coverage may provide investors with more helpful information and insight vis-à-vis traditional debt tender offers, in which only the most basic terms are summarized in a press release.

If an issuer conducting a Five Day Tender Offer must adhere

Similarly, there is also some uncertainty surrounding whether an “early tender” fee or a waterfall debt tender structure would be permissible in a Five Day Tender Offer context.¹³ The Staff likely would not permit such practices due to the abbreviated nature of the offering period. In addition, at least one

¹³ See SEC Comment Letter, Nicole Crafts LLC (October 21, 2011).

¹⁴ See id. id. at sect. 14.
A senior Staff member has stated at a recent securities law conference that a waterfall structure could not be incorporated into a Five Day Tender Offer. While certain innovative market participants may well seek to test the outer boundaries of the No-Action Letter before formal Staff guidance can be published on this and other issues, the mandatory widespread dissemination of offers is likely to attract sufficient regulatory scrutiny to deter aggressive market practices.

What remains to be seen is exactly how widespread and accepted Five Business Day Offers will become in the long run. One thing is certain, however, market participants will do their best to adapt current practices to take full advantage of all the benefits afforded by the No-Action Letter, which going forward will allow issuers to conduct their tender and exchange offers in as little as five business days. Some might even say less than five business days given that such offers can expire as early as 5:00 p.m. (Eastern time), on the date of expiration, as opposed to midnight, the expiration time traditionally imposed in order for the last day to count as a full business day.


16 In contrast, Rule 14e-1(b) of the Exchange Act of 1934, as amended, requires that tender offers remain open for at least ten business days following any announced increase or decrease in the consideration offered. 17 C.F.R. § 240.14e-1(b) (2008).
Five Day Tender Offers: Conditions and Timelines

By James Moloney, Sean Sullivan and Todd Trattner of Gibson, Dunn & Crutcher LLP

In January 2015, the Division of Corporation Finance (the “Staff”) of the Securities and Exchange Commission (“SEC”) issued a no-action letter (the “No-Action Letter”) permitting issuers, including their parents or wholly-owned subsidiaries, to conduct five business day tender offers for any and all non-convertible debt securities when certain conditions are met (“Five Day Tender Offers”). This expands a nearly 30-year old interpretive position pursuant to which the Staff has generally allowed for an abbreviated offering period of seven-to-ten calendar days, but limited that position to tender offers for investment grade debt securities. The abbreviated offer period is substantially less than the 20-business day minimum requirement established by Rule 14e-1 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). The No-Action Letter also permits this shortened timeframe to be utilized in exchange offers in which non-convertible debt securities are issued for nearly identical debt securities that are the subject of the tender offer, as long as certain other conditions are met.

Five Day Tender Offer Conditions

In order to be eligible to conduct a Five Day Tender Offer consistent with the framework outlined in the No-Action Letter, a tender offer generally must satisfy the conditions described below. All times noted below are Eastern time.

The Offer

Immediate Widespread Dissemination. The announcement of the offer must be made by “Immediate Widespread Dissemination,” which means that it must be announced in a press release through a widely disseminated news or wire service and disclose:

- the basic terms of the offer (identity of the offeror, class of securities sought, type and amount of consideration, expiration date of the offer); and

- the Internet address where the offer and letter of transmittal (if any) and other instructions and documents (including a form of guaranteed delivery instructions) can be found.

The announcement must be made by 10:00 a.m. in order for such day to count as the first day of the Five Day Tender Offer. In addition to Immediate Widespread Dissemination, under the Five Day Tender Offer framework, an offeror is required to (i) use commercially reasonable efforts to send the press release via electronic mail to all investors subscribing to corporate action or similar lists, (ii) use other customary methods to expedite the dissemination of information concerning the offer to beneficial holders of the debt securities and (iii) issue a press release promptly after the closing of the offer setting forth the results.

Current Report on Form 8-K Filing. If an issuer is a reporting company under the Exchange Act (including a voluntary filer), it must provide the press release as an exhibit to a Current Report on Form 8-K filed with the SEC prior to 12:00 noon, in order for such day to count as the first day of the five business day offer period.

1 © 2015 Gibson, Dunn & Crutcher LLP. James J. Moloney is Co-Chair of the Securities Regulation and Corporate Governance Practice Group and is a Partner in the Corporate Transactions Group in Gibson Dunn’s Orange County office. Sean Sullivan and Todd Trattner are Associates in the Corporate Transactions Group in Gibson Dunn’s San Francisco office.


3 SEC No-Action Letter, Cahill Gordon & Reindel LLP (January 23, 2015). The abbreviated offer period described in the No-Action Letter supersedes the letters issued to Goldman, Sachs & Co. (March 26, 1986); SEC No-Action Letter, Salomon Brothers Inc. (March 12, 1986); SEC No-Action Letter, Salomon Brothers Inc. (October 1, 1990); and any similar letters relating to abbreviated offering periods in non-convertible debt tender offers. None of the foregoing letters should be taken to express the Division’s position with respect to tender offers commencing after [January 23, 2015]. SEC No-Action Letter, Cahill Gordon & Reindel LLP (January 23, 2015).
Changes to the Offer. Any changes to the offer that are material must be communicated by Immediate Widespread Dissemination by 10:00 a.m.:

- at least five business days prior to expiration of the offer for any change in the consideration offered;
- at least three business days prior to expiration of the offer for any other material change to the offer.

If the issuer is a reporting company under the Exchange Act (including a voluntary filer), the issuer must describe any change in the consideration being offered in a Current Report on Form 8-K filed with the SEC prior to 12:00 noon, at least five business days prior to expiration of the offer. The ability to announce a price change with only five business days remaining in the offer is a substantial reduction in time from the ten business days that would otherwise be required under Rule 14e-1(b) of the Exchange Act.

Guaranteed Delivery Procedure. The offer must permit tenders from holders through the expiration of the offer using a guaranteed delivery procedure, in which a certification by or on behalf of a holder guarantees that the holder is tendering securities beneficially owned by it and that the delivery of the securities will be made no later than the close of business on the second business day after expiration.

Withdrawal Rights. The offer must provide for withdrawing rights that are exercisable at least until the earlier of (i) the expiration date of the offer and (ii) the tenth business day after commencement of the offer. In the event that the offer is extended, the offer must provide for withdrawal rights on or before the second business day following completion of the offer. In any event, the offer must be open to all holders for the first time.

Parties and Consideration

Issuer. The offer must be made by the issuer, a direct or indirect wholly-owned subsidiary of the issuer or a parent company that directly or indirectly owns 100% of the capital stock (other than directors' qualifying shares) of the issuer.

Non-Convertible Debt Securities. The offer may be made for a class or series of non-convertible debt securities, and can be made for such securities regardless of the rating of the debt securities. This differs from SEC guidance, which limited the shortened tender offer framework to offers associated with investment grade debt securities. The offer must be for an offer and an extension of the offer. The consideration must also allow the tenderer to elect to receive more than one class or series of debt securities either as part of an exchange offer or purchase price offer.

Consideration. Consideration for the Five Day Tender Offer must consist of (i) cash, (ii) Qualified Debt Securities, as defined in the No-Action Letter, or (iii) a combination of cash and Qualified Debt Securities.

Benchmark Pricing. The consideration offered may be in a cash amount or as a combination of cash and Qualified Debt Securities as defined in the No-Action Letter. In the case of Qualified Debt Securities, the consideration must be based on a specified benchmark.

No Early Settlement. The offer must provide that the offeror will not pay the consideration offered until promptly after the expiration date, pursuant to Rule 14e-1(c). This condition effectively precludes payment of the consideration offered on a rolling basis as securities are tendered in the offer.

Open to All Holders. The offer must be open to all record and beneficial holders of the debt securities subject to the offer. In the case of an exchange offer in which Qualified Debt Securities are offered, the offer of new debt securities must be restricted to Qualified Institutional Buyers (as defined in Rule 144A.
under the Securities Act of 1933, as amended (the Securities Act), QIBs) and/or non-U.S. persons (within the meaning of Regulation S under the Securities Act) (collectively, Eligible Exchange Offer Participants) in a transaction that is exempt from the registration requirements of the Securities Act. Holders that are not Eligible Exchange Offer Participants (or an affiliate thereof) must be given an option concurrent with the offer to receive cash, from either the offeror or a dealer-manager, for such holders’ debt securities in a fixed amount (set forth at the commencement of the offer) that approximates the value of the Qualified Debt Securities being offered, as determined by the offeror in its reasonable judgment. The shortened tender offer framework is not available for partial offers.

**Exclusions**

**Senior Debt.** The offer may not be financed with debt that (i) has obligors, guarantors or collateral (or a higher priority with respect to the subject debt securities) that differ from the subject debt securities, (ii) has a weighted average life to maturity that is shorter than that of the subject debt securities, (iii) is otherwise subject to reimbursement of the subject debt securities, or (iv) is otherwise subject to reimbursement of the subject debt securities, based on any one or more events or transactions that occur simultaneously with the commencement of the offer.

**Consent Solicitation.** The offer may not be made in connection with a solicitation of consents to amend the indenture, form of security or note or other agreement governing the subject debt securities.

**Default.** The offer may not be made if a default or event of default exists under the Indenture or any other indenture or material credit agreement to which the issuer is a party.

**Bankruptcy or Insolvency.** The offer may not be made if the issuer is the subject of bankruptcy or insolvency proceedings, has commenced a solicitation of consents for a “pre-packaged” bankruptcy proceeding or if the board of directors of the issuer has authorized discussions with creditors of the issuer to effect a consensual restructuring of the issuer’s outstanding debt.

**Change of Control or Other Extraordinary Transactions.** In addition, the offer may not be:

- made in anticipation of or in response to, or concurrently with, a change of control or other extraordinary transaction involving the issuer, or a parent company of the issuer, or a material change in control of the issuer, or in any other extraordinary transaction;
- made in connection with the tender offer of another person for the issuer’s securities;
- made in anticipation of or in response to, or concurrently with, any tender offer to purchase or exchange securities from the issuer or any other tender offer involving the issuer’s securities;
- commenced within ten business days after the announcement or consummation of the transaction in connection with which the tender offer was made.

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Illustrative Timeline: Five Day Tender Offer Framework

The following timeline sets forth an illustrative schedule for conducting an offer consistent with the Five Day Tender Offer framework set forth in the No-Action Letter. Only business days are included in the timeline.

Five Day Tender Offer Framework

<table>
<thead>
<tr>
<th>Monday</th>
<th>Thursday</th>
<th>Friday</th>
<th>Tuesday</th>
<th>Monday (Week 13)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commencement of the Offer</td>
<td>Day Prior to Expiration of the Offer</td>
<td>Expiration of the Offer</td>
<td>Delivery of Securities</td>
<td>If Offer has not been Consummated</td>
</tr>
<tr>
<td>10:00 a.m.—Deadline for Immediate Widespread Dissemination of the offer.</td>
<td>9:00 a.m.—Announce the basic terms of the offer and the Internet address.</td>
<td>2:00 p.m.—Disclose by press release the exact amount of consideration and the interest rate if a range was used to determine the interest rate.</td>
<td>Close of Business—Deadline for holders to deliver securities that were tendered via guaranteed delivery procedures.</td>
<td>At Any Time—Withdrawal allowed at any time on or after this date if subject debt securities were not accepted for purchase and paid for.</td>
</tr>
<tr>
<td>• Announce the fixed amount of the interest rate or the spread used for determining the interest rate for an offer of Qualified Debt Securities.</td>
<td>• Prior to Expiration—Tender withdrawals allowed before expiration of the offer.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• In the case of an offer of Qualified Debt Securities, announce the minimum acceptance amount, if any.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12:00 noon—Deadline for reporting companies to file a Current Report on Form 8-K.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Other Key Dates When Changing Consideration or Other Material Terms

<table>
<thead>
<tr>
<th>Monday (Week X)*</th>
<th>Wednesday (Week X)</th>
<th>Friday (Week X)</th>
<th>*Week X refers to the week of the new expiration date of the amended offer</th>
</tr>
</thead>
<tbody>
<tr>
<td>10:00 a.m.—Deadline for Immediate Widespread Dissemination of changes in consideration offered.</td>
<td>12:00 noon—Deadline for reporting companies to file Form 8-K addressing changes in consideration offered.</td>
<td>Prior to Expiration—Tender withdrawals allowed before expiration of the offer.</td>
<td></td>
</tr>
</tbody>
</table>

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Potential Changes in Practice

The following table sets forth some of the key differences between shortened offers conducted prior to the release of the No-Action Letter and offers that can be conducted consistent with the Five Day Tender Offer framework set forth in the No-Action Letter:

<table>
<thead>
<tr>
<th></th>
<th><strong>Practice prior to the release of the No-Action Letter</strong></th>
<th><strong>Practice consistent with the Five Day Tender Offer framework set forth in the No-Action Letter</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit Rating</strong></td>
<td>Shortened tender offers were limited to investment grade non-convertible debt securities.</td>
<td></td>
</tr>
<tr>
<td><strong>Time Offer Held Open</strong></td>
<td>Shortened offers were held open for as few as seven to ten calendar days.</td>
<td>Shortened offers may be held open for as few as five business days.</td>
</tr>
<tr>
<td><strong>Dissemination</strong></td>
<td>Shortened offers were disseminated on an expedited basis.</td>
<td>Shortened offers must be delivered via Immediate Widespread Dissemination (as described above).</td>
</tr>
<tr>
<td><strong>Commencement</strong></td>
<td>Shortened offers were often delivered to the DTC a few minutes before midnight on the commencement date.</td>
<td>Shortened offers must be announced by 10:00 a.m. (Eastern), on the commencement date.</td>
</tr>
<tr>
<td><strong>Current Report on Form 8-K</strong></td>
<td>No Current Report on Form 8-K filing was required for shortened offers and few companies voluntarily filed such 8-Ks.</td>
<td>Reporting companies must provide the press release in a Current Report on Form 8-K filed with the SEC prior to 12:00 noon (Eastern) on the commencement date.</td>
</tr>
<tr>
<td><strong>Exchange Offer</strong></td>
<td>Shortened offers were limited to cash-only tender offers. Exchange Offers were not eligible for abbreviated offering period.</td>
<td>The consideration offered in shortened offers may be (i) cash, (ii) Qualified Debt Securities or (iii) a combination thereof.</td>
</tr>
<tr>
<td><strong>Guaranteed Delivery</strong></td>
<td>Shortened offers were not required to provide a guaranteed delivery procedure.</td>
<td>Shortened offers are required to provide a guaranteed delivery procedure by means of a certification.</td>
</tr>
<tr>
<td><strong>Withdrawal &amp; Settlement</strong></td>
<td>Shortened offers were not required to provide for withdrawal rights and could provide for early settlement with payment made on a rolling basis as securities were tendered.</td>
<td>Shortened offers must provide withdrawal rights and an offeror may not pay the consideration offered until promptly after expiration of the offer.</td>
</tr>
<tr>
<td><strong>No Exit Consents</strong></td>
<td>Shortened offers could be made in connection with an exit consent that would typically allow for the stripping of covenants in the indenture.</td>
<td>Shortened offers may not be made in connection with an exit consent. The stripping of covenants in the related indenture is not allowed.</td>
</tr>
<tr>
<td><strong>Disqualifying Circumstances</strong></td>
<td>Shortened offers were not allowed in connection with other change of control circumstances.</td>
<td>Shortened offers are not allowed in connection with other change of control circumstances or tender offers.</td>
</tr>
</tbody>
</table>

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Wake-Up Call for Private M&A Deal Structuring

By Ethan Klingsberg, Partner, Cleary Gottlieb Steen & Hamilton LLP

The widespread practice in private acquisitions of combining a “subsidiary merger” acquisition structure with release, indemnification, and escrow arrangements, which purport to bind the target stockholders, received a jolt from the Delaware Court of Chancery’s recent decision in Cigna v. Audax. The merger structure, ubiquitous in acquisitions of publicly traded targets, has emerged as the structure of choice in acquisitions of private targets that have a number of non-insider stockholders from whom it is not practicable to obtain an agreement to sell their stock during the period prior to signing a definitive acquisition agreement.

When preparing merger agreements in this private M&A context, the parties regularly layer in provisions that have their origin in stock purchase agreements, as opposed to public-company merger agreements, including the release, indemnification, and escrow provisions addressed by the Court. This new decision is a wake up call for acquirors to the risks that come with this approach and the care that is required to address these risks.

How Did We Get Here?

Many private companies, especially start-ups, incentivize their employees with equity and raise capital from a spectrum of sources. These companies often end up with a stockholder profile that includes numerous low level employees, some former employees, some strategic investors and a bunch of individual, fund and institutional investors that are not actively involved with governance or oversight of the company. For an acquiror that wants to enter into a definitive acquisition agreement quickly and confidentially, the idea of collecting signatures to a stock purchase agreement from each of these non-insider holders is both unappealing and impractical.

Fortunately, the stockholder profile will regularly include not only the unwieldy group, but also a small number of holders that hold the requisite voting power over the non-insider stockholders. With the consent of these holders, the merger structure permits the acquiror to acquire 100% of the target company’s stock in a single step, subject to the right to pursue appraisal rights by the non-consenting holders.

Meanwhile, the acquiror wants to have the customary protections of a stock purchase agreement: broad releases from the target stockholders, an indemnity from the target stockholders for breaches of the representations and warranties about the target's operations, and an escrow to secure at least part of these indemnity obligations. Is this asking for too much?

Tension between the Merger Structure and Private M&A Obligations of Target Stockholders

The efficiency of the merger agreement structure, in being able to squeeze out the non-insiders without their consent or involvement, has come at a cost: in many cases, the acquirors are unable to secure the customary protections and indemnification from the target stockholders. As a result, acquirors are increasingly seeking to address the indemnification and escrow provisions in merger agreements in a manner that is more favorable to them. This is a significant departure from the structure of prior merger agreements, which typically included provisions that allowed the acquiror to secure indemnification and escrow from the target stockholders in the event of breaches of representations and warranties. In contrast, the new structure seeks to address these risks in a manner that is more favorable to the acquiror.

1 My partners Benet O’Reilly, Glenn McGrory and Matt Salerno contributed ideas and insights to this article.
Quick Fix?

Undaunted by this chasm between the merger statute and the undertakings of a stock purchase agreement, practitioners regularly relied upon a solution that leveraged the customary letter of transmittal used in mergers for the exchange of a target holder’s canceled shares for the merger consideration. The letter of transmittal had traditionally been a relatively simple document whereby the target holder would confirm ownership of its shares as part of the process of transmitting the shares in exchange for the merger consideration. The clever idea these practitioners had was to bulk up the letter of transmittal, sometimes to the extent that it would go on for several pages, and turn it into an opportunity to obtain a panoply of agreements and obligations to benefit the acquiror, the most valuable of which were releases and indemnities.

Finally, a target stockholder said, “No thanks, I’m passing on signing this burdensome letter of transmittal that would impose upon me obligations not provided for in the merger statute, but I do want my merger consideration as required by the merger statute.” Or, in other words, “Hold the obligations, but I’ll take the cash.” The Court of Chancery agreed and held that in order to bind the target stockholder, the obligation to sign the letter of transmittal must be a condition to receipt of the merger consideration.

Revisiting What Constitutes Merger Consideration

Requiring target stockholders to execute an obligation-laden letter of transmittal as a condition to receipt of their merger consideration is not the only technique for addressing the disconnect between the merger structure and the imposition on target stockholders of obligations to the acquiror. An alternative is to attempt to bake these obligations into the merger agreement itself and thereby into the merger consideration itself. In other words, the right to the merger consideration comes with the limitations imposed by the obligations. The Court discusses this concept at length and concludes that there is, in certain instances, merit to this approach. Although the Court does not provide entirely precise guidance, the following principles emerge:

- **Releases and Indemnities for Amounts Beyond the Merger Consideration.** Obligations that are not defining limits on the actual merger consideration cannot be deemed to be part of the merger consideration and therefore will not be enforceable against target stockholders simply by virtue of the closing of the merger. Examples would include releases and undertakings to pay amounts in excess of the merger consideration. Even if these obligations are written into the merger agreement as obligations of the target stockholders, the effectiveness of the merger, by itself, is not going to be sufficient to cause these obligations to become binding on target stockholders.

- **Escrows, Holdbacks and Earn-Outs.** Provisions in the merger agreement for setting aside funds that would otherwise have been merger consideration—e.g., in an escrow account or as a holdback—to secure post-closing indemnity and purchase price adjustment obligations, or to function as an earn-out, should be enforceable if drafted appropriately, as these structures may be viewed as creating contingent rights of target stockholders to receive additional consideration, as opposed to new obligations. The Court does not directly rule on the enforceability of these provisions, but the dicta and precedents are supportive.

- **Merger Consideration Clawbacks for Indemnity Claims and Purchase Price Adjustments.** The most interesting area is whether the acquiror may retain the merger consideration following the closing of the merger. If the acquiror is a continuing entity, as the target’s stockholders are, then the acquiror would receive no further compensation—
the target stockholder based on purchase price adjustments or indemnification claims. According to the Court, whether these clawback rights will be enforceable against target stockholders by virtue of the merger should depend on the level of visibility that the stockholders have into the likelihood and extent of the clawback right being exercised.

The rationale for applying this standard is that target stockholders have had a voice in the adoption of the merger agreement. However, to what extent and in what manner that voice is translated into greater visibility of clawback rights will depend on the enforceability of the merger agreement and the relative bargaining power of the acquiring company, which in turn will depend on the level of visibility that the target stockholders have into the likelihood and extent of the clawback right being exercised.

The Court’s decision to use this standard for determining the enforceability of indemnity clawbacks is distressing. Indemnity clawbacks, just like contingent rights to escrows, holdbacks and earn-outs, regularly do not meet the Court’s test of having to be “ascertainable, either precisely or within a reasonable range of values.” If they were, the parties would have just adjusted the purchase price up front. The ultimate impact of indemnities, escrows, hold backs and earn-outs is arguably always unascertainable at the time of adoption and that is why these mechanisms are used. Moreover, since the consequences of these provisions will be based entirely on representations, warranties, or financial or other metrics for the very company with which the plaintiff is already familiar as an equity investor, the Court’s efforts to protect the target stockholder from these provisions seem like an overreach.

When applying this standard, at one end of the spectrum are post-closing clawbacks of all the merger consideration, without limitations as to time and scope of damages, and based on potential breaches of a broad set of representations and warranties made by the target company. The consequence of imposing such a broad limitation on the merger consideration, according to the Court, is that “the value of the merger consideration itself is not, in fact, ascertainable, either precisely or within a reasonable range of values.” As a result, such a broad clawback right conflicts with the merger statute and is not enforceable as a component of the merger consideration.

At the other end of the spectrum are post-closing clawbacks of merger consideration based on well-defined purchase price adjustment provisions that include specific financial statement-based formulas and time limitations for resolution (e.g., a typical, post-closing true-up of an adjustment to the purchase price derived from the closing balance sheet). Here, the Court’s dicta implies that this type of well-defined clawback should be enforceable, but ultimately the Court leaves the issue wide open as does the one precedent that addresses the subject and that the Court cites approvingly.

An even more grey area is inhabited by indemnity clawbacks that are limited in time (e.g., a one to three year survival period) and limited in scope as to damages and the nature of the subject matter covered by the indemnification. In the case at hand, the Court said that the acquisitions that are included indemnity payments from the merger consideration provide in the event of indemnifying target shareholders to an extent that is necessary and proper in the event of breaches of representations and warranties, such as a breach of warranty of title and a fraud.

In sum, the Court provides insufficient clarity on the enforceability of indemnities fashioned as clawbacks of the merger consideration. For acquirors, this lack of a clear path to
enforceability in the context of indemnity claims can be costly, especially in the context of settlement discussions, given the other impediments, such as factual disputes, that often make it difficult for acquirors to recover on such claims.

- **Stockholder Representative Appointments.** Another unsettled area noted by the Court, but not addressed, is the authorization of stockholder representatives to act post-closing on behalf of non-consenting target stockholders—e.g., in connection with defending and settling indemnification claims. Even if, by virtue of the merger alone, the right to clawback merger consideration to cover indemnity claims were enforceable, should the effectiveness of the merger automatically bind a target stockholder to the agency of the stockholder representative?

Despite the efficiencies and practicality of this regularly used mechanic of a stockholder representative, the merger statute itself does not, at least on its face, appear to have a clear hook for binding a stockholder to the appointment of such an individual rather than the holder's consent. This may be an area where action by the legislature would be of value. One idea for legislation would be a scheme where target stockholders are deemed to have accepted the representative's appointment unless they affirmatively opt out following a notice period.

**Advice for Acquirors**

Practitioners will be mistaken and misguiding their acquiror clients if they read this new Chancery Court decision as sending a message that use by acquirors of a merger structure when seeking private M&A style protections is inadvisable or somehow contrary to public policy. The quick fix of the letter of transmittal is off the table. But all is not lost.

- **Support Agreements and Joinders.** Nothing in the decision should be read to imply that broad indemnity obligations, even if implemented in the context of a merger structure, would be unenforceable as a contractual matter due to vagueness, public policy or any other reason. The Court makes clear that, even in the context of a merger structure, “individual stockholders may contract—such as in the form of a Support Agreement—to accept the risk of having to reimburse the buyer over an indefinite period of time for breaches of the Merger Agreement’s representations and warranties.” Accordingly acquirors should keep in mind the following considerations:
  - **Undertakings and joinders, not just resolutions.** Assure that at least all the insider stockholders, simultaneously with their execution of consents to the adoption of the merger agreement, execute express undertakings and joinders relating to releases, confidentiality, cooperation, indemnification, stockholder representative appointment and all other matters that arguably go beyond the express terms of the merger consideration. These undertakings and joinders should be in addition to their written consents to the stockholder resolutions that adopt the terms of the merger agreement, even if the terms of the merger agreement and the resolutions reflect these matters. “The merger agreement, even though approved by the consenting stockholders, remains a contract solely between the acquiror and the target company,” in the words of the Chancery Court. Accordingly, express contractual undertakings and joinders, and not the resolutions approving the merger, are the advisable means to bind the signatory stockholders.
  - **Leverage Drag-Along Rights, Closing Conditionality and Pro Rata Formulas.** Many private companies already have investor and stockholder agreements in place that bind their stockholders with broad drag-along obligations that require that the holders not only vote in favor of change in control transactions supported by the majority stockholders, but also sign up for all obligations ancillary to the change in control transaction. Acquirors should not overlook these valuable rights buried within investor and stockholder agreements, which agreements are typically otherwise irrelevant to the acquisition transaction.
of these executed undertakings from all or at least a minimum percentage of the non-insider stockholders as one of the conditions to closing.

A further mechanic to protect the acquiror and cause the insider stockholders to obtain these undertakings is to provide for the following adjustment to the pro rata formula that specifies how the indemnity obligations are allocated among the target stockholders. Rather than allocating the indemnity obligations pro rata based on the respective portions of the merger consideration received by each stockholder relative to the aggregate consideration received by all stockholders as would be customary, acquirors should consider insisting upon allocation of these obligations pro rata relative only to the pool of stockholders that have signed undertakings or joinders to be bound contractually by the indemnity.

Thus, for example, if stockholders representing only 85% of the shares have agreed to be bound by the indemnity, that group should be fully responsible for 100% of the indemnification obligations not covered by escrow. This approach is particularly important in the case of indemnities for breaches of “fundamental” representations and warranties, which are often uncapped and of indefinite duration.

- Draft the Merger Agreement to Enhance Enforceability. In the absence of separate undertakings and joinders, acquirors can increase the chances of enforceability of target stockholder obligations by drafting merger agreements in a manner that makes clear that these obligations are part of the merger consideration and that they are subject to parameters.
  - Contingent Rights to Merger Consideration, Not Post-Closing Set-Asides. Amounts that are set aside for future release to the target stockholders pursuant to escrow, holdback and earn-out provisions should be described as amounts to which the target stockholders have contingent rights that are part of their merger consideration, as opposed to amounts that are set aside or taken back a moment in time after the merger consideration is determined and payable.
  - Converting Clawback Rights into Contingent Rights to Merger Consideration. If, as the Court implies, contingent rights to escrow, hold-backs and earn-outs are not problematic, while indemnities fashioned as clawbacks need to meet the troublesome “reasonablyascertainable value” standard, it may be worthwhile for acquirors to structure the merger consideration in a manner that effectively converts the indemnity clawback into a contingent right.
    - For example, the merger agreement could provide for a contingency right to be exercised
      from escrow, an amount that is committed to being released in a manner that triggers
      the stockholder’s execution of a joinder to the indemnity.
    - An even better approach is to have the merger agreement provide for a contingent right to be exercised
      from escrow, an amount that is committed to being released in a manner that triggers
      the stockholder’s execution of a joinder to the indemnity.
  - Clawback Rights Baked into the Merger Consideration. In any event, obligations to pay
    indemnification and purchase price adjustment amounts should be referenced in the section
    that provides for the delivery of the merger consideration. In addition, they should be
    described as obligations that give rise to clawback rights of the acquiror against the merger
    consideration and as integral components of and limitations on the merger consideration.
  - Time Limitations. Acquirors should consider inclusion of time limitations on all obligations
    of the target stockholders that give rise to clawback rights against the merger consideration,
    even if they are simply restatements of the applicable statute of limitations. The greater
    the challenges the acquiror will face in obtaining contractual undertakings from target
stockholders, the more advisable to include meaningful time limitations to enhance the likelihood of enforceability without these separate undertakings.

The merger structure should continue to provide an effective means for acquirors to proceed quickly and confidentially to a definitive acquisition agreement with privately held targets that locks in the target to a sale of 100% of the equity, especially when these targets have numerous non-insider stockholders. A well-advised acquiror should be able to craft an approach to the merger agreement and ancillary support agreements in ways that do not leave the acquiror with a bleak choice between a merger agreement structure that provides inadequate post-closing protections, and a stock purchase agreement structure that is characterized by unacceptable risks of failing to acquire 100% of the equity as well as impediments from the perspectives of speed and confidentiality.

Courts Increasingly Skeptical of the Value of Disclosure-Only Settlements

By Tim Mast, Tom Bosch, and Nicholas Howell of Troutman Sanders LLP

In 2013 and early 2014, courts in Delaware and other jurisdictions increasingly began to scrutinize attorneys’ fee awards in disclosure-only settlements resolving shareholder challenges to merger transactions. In several decisions, courts reduced or denied plaintiffs’ attorneys’ fees because the settlements involved only nonmaterial additional disclosures. Delaware courts have been relatively quiet on this issue since the Court of Chancery's February 2014 decision in In re Medicis Pharm. Corp., S’holders Litig.; however, several recent decisions from the New York Supreme Court's Commercial Division and one decision from the Northern District of California indicate that courts will continue to eschew the practice of “automatic” fee awards in favor of awarding fees based on the benefit that the additional disclosures provide to shareholders and, in appropriate circumstances, rejecting settlements and fee requests.

Reduction of Fees. In June 2014, after certifying a class for settlement purposes, Judge Charles E. Ramos of the New York Supreme Court's Commercial Division rejected a request by plaintiff's counsel for $465,000 in fees in Schumacher v. NeoStem, Inc. Although Judge Ramos believed that plaintiff's counsel had “undoubtedly achieved value” for the class by securing additional disclosures and several corporate governance reforms, he opined that the benefit to shareholders was “limited” because the settlement did not provide the shareholders any monetary relief. Consequently, Judge Ramos reduced the fee award to $125,000.

Several months later, in West Palm Beach Police Pension Fund v. Gottdiener, Judge Marcy Friedman of the Commercial Division approved a disclosure-only settlement, but applied the lodestar method to reduce an unopposed fee request from the $500,000 requested to $379,566.50 plus $36,637.65 in unreimbursed expenses. Judge Friedman declined to apply a multiplier to increase the amount of the fees awarded because “the contingency risk that the plaintiff faced was insubstantial, given the ubiquity of settlements in shareholder derivative actions challenging mergers based on insufficient disclosures.”

4 Id.
5 Id.
7 Id. at *8-9.
Similarly, in *St. Louis Police Retirement System v. Severson*, Judge Yvonne Rogers of the Northern District of California also approved a disclosure-only settlement and used the lodestar method to reduce a fee request of $1,650,000 to $543,018.75. In *Gordon v. Verizon Communications, Inc.*, Judge Melvin L. Schweitzer of the New York Supreme Court's Commercial Division rejected a proposed disclosure-only settlement and request for attorneys' fees because the additional disclosures were immaterial. Judge Schweitzer described the supplemental disclosures as “unnecessary surplusage” that “individually and collectively fail[ed] to materially enhance the shareholders’ knowledge” of the merger. Thus, he held that any award of legal fees would constitute a misuse of corporate assets.

Denial of Settlements. In December 2014, in *Gordon v. Verizon Communications, Inc.*, Judge Melvin L. Schweitzer of the New York Supreme Court's Commercial Division rejected a proposed disclosure-only settlement after finding that the defendant’s failure to make “full disclosures of material facts bearing on the shareholders’ proxy vote,” the case did not involve extraordinary risk, complexity, or effort on behalf of plaintiff’s counsel. Judge Rogers also scrutinized the plaintiff counsel’s request for $51,231.89 in expenses and awarded only $36,410.78.

Most recently, in *City Trading Fund v. Nye*, Judge Shirley W. Kornreich of the Commercial Division also denied approval of a disclosure-only settlement. Judge Kornreich criticized the plaintiffs’ claims for their “downright frivolity” because the plaintiffs neither alleged material omissions nor settled for material supplemental disclosures.

The plaintiffs responded by voluntarily dismissing their claims.

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9 Id. at *20-21.
10 Id. at *23.
12 Id. at *16, *21.
13 Id. at *19, *21.
15 Id. at *37.
16 Id. at *33.
Transaction Costs: Negotiating Their Tax Benefit

By Saba Ashraf & Wayne Strasbaugh, Partners of Ballard Spahr LLP

In any merger or acquisition, parties incur costs beyond payment of the purchase price. Transaction costs can include compensatory payments (option cancellation payments, bonuses, etc.) and professional fees (legal, accounting, and investment banking fees). Often, there are extensive negotiations over the tax benefits associated with these costs.

Negotiations involving tax benefits can arise in a number of circumstances, including the following: (i) A purchaser assuming responsibility for the payment of a significant target transaction cost may be advised that the cost is not as high after the associated tax benefit is taken into account—leading to negotiations with the seller for the purchaser to claim the tax deduction. (ii) A target corporation may not have taxable income in a pre-closing period against which to offset a tax deduction—leading to an offer to allow the purchaser to claim the deduction, if it pays the selling shareholders for the tax benefit.

A basic premise of M&A tax structuring is that in evaluating an acquisition of a business, a purchaser should take into account the tax benefit resulting from the structure. For example, if a purchase of assets, or stock with an election under Code1 Section 338(h)(10) or Code Section 336(e) yields a stepped-up tax basis, and therefore tax depreciation/amortization deductions, that should certainly be taken into account by the parties. However, negotiating which party may claim tax deductions for transaction costs and how much should effectively be “paid” for the associated tax benefits can be a bit tricky, and parties should proceed cautiously, for the reasons discussed below:

• Capitalized, amortized or deducted. For many transaction costs, there simply will be no current tax deduction. While costs may often be deducted as ordinary and necessary business expenses under Code Section 162, a cost that is a “capital expenditure” may not be currently deducted. In particular, a taxpayer must capitalize an amount paid to purchase an asset for productivity if the asset is productive. However, certain costs that are incurred in connection with the acquisition or disposition of property may be capitalized when the bright line date hurdle is cleared, if a cost is considered to be an “inherently facilitative” cost; i.e., a cost that is necessary to acquire the property. Costs that are not capitalized include compensation paid to target management.

○ There is some good news. One important transaction cost that is generally deductible under Section 162 is the cost of compensation triggered by the acquisition, including payments related to cancellation of nonqualified stock options and bonuses paid to target management.

• Timing of deduction. Even though compensatory payments are generally deductible, whether they may be deducted on the pre-closing tax return (generally, though not always, benefitting the seller), or the post-closing tax return (generally, though not always, benefitting the purchaser) is an issue that is governed by a multitude of tax rules. The application of some of these rules is not very clear. 3 A discussion of each of these tax rules is outside the scope of this advisory.

1 References to Code Sections are to Sections of the Internal Revenue Code of 1986, as amended.

2 The bright line date is the date the business combination is complete. Generally, the bright line date is the date of a binding written agreement or the date the board of directors or other appropriate personnel authorize or approve the material terms, if such authorization or approval is required. Even if the bright line date is an issue that is governed by a multitude of tax rules. The application of some of these rules is not very clear. 3 A discussion of each of these tax rules is outside the scope of this advisory.

3 Generally, these rules include Section 83(h) of the Code, the consolidated return regulations (where the target corporation is entering or leaving a consolidated group), the method of accounting of the payor, and the time for economic performance under Sections 404(a) (5) and 461(h) of the Code.
and—most discouraging—there is not absolute certainty as to how most of them should apply. In the absence of clear guidance (and sometimes in spite of relatively clear guidance), many parties agree contractually on the timing of the deduction, and therefore which party may claim the tax benefit on its return (or the return of target at a time when the target is owned by such party). It is important to understand that while contractual agreement on the taking and timing of a deduction may be helpful, it is not binding on the Internal Revenue Service ("IRS"). The IRS may not agree with the position the parties have taken. Unfortunately, the IRS disagreement will likely not "turn up" until audit of one of the parties to the deal—which likely will be years later when the opportunity for the audited taxpayer to obtain a purchase price adjustment from the other party may have passed.

- **Quantification of tax benefit.** Once the timing and amount of the tax benefit are known, the parties may agree to quantify the tax benefit in determining the exchange price. There are generally two approaches to doing this. One approach is to incorporate the agreed-upon value in the purchase price. This is an obvious exchange. The other approach is to incorporate the value of the tax benefit in the purchase price. The parties may agree to quantify the value of the tax benefit as of the date of contract execution and incorporate the agreed-upon value in the purchase price. This, in our experience, does not frequently happen.

All parties to business transactions want to maximize their return. It is tempting to use tax benefits of transaction costs either to provide extra return to a party or to make the transaction costs the party is incurring a bit easier to accept. However, parties should tread carefully in this area. While ultimately dependent on the underlying facts, there may be uncertainty as to the existence of the tax benefit. Further, any "trading" of the tax deduction and an agreement that it be allocated to a certain party—and therefore claimed by it—may be inconsistent with the governing tax rules.

**Food for Thought: Conflicting Views on the "Knowing Participation" Element of Aiding & Abetting Claims**

*By Kevin Miller, a Partner of Alston & Bird LLP*

Despite the Delaware Court of Chancery’s decision in *Pontiac General Employees Retirement System v Healthways*, C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014) (transcript ruling) denying motions to dismiss claims against a borrower and the administrative agent of a credit facility, many banks continue to believe that including a provision in credit agreements that allows the banks to require the prompt repayment of their loans if a dissenting stockholder’s nominees are elected as a majority of the board of a borrower is an appropriate and effective way to protect the financial interests of the banks and their stockholders.

From the banks’ perspective, the election of a dissenting stockholder’s nominees as a majority of the board of the borrower is likely to result in a material change in the business strategy and objectives of the board, the persons legally responsible for managing the business and affairs of the borrower. Given that

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risk and that they are agreeing to lend hundreds of millions if not billions of dollars based on diligence relating to the current and proposed future business, operations, financial condition and prospects of the borrowers, the banks justifiably want protection in the event of a material change in the directors comprising a majority of the borrower’s board.

For lenders, credit evaluation and repayment protection are not solely a matter of financial covenants but also include knowing your borrower and understanding its business strategy and objectives. As a consequence, the banks continue to believe that absent well pled allegations of complicity or collusion with the board of the borrower to provide entrenchment benefits (e.g., as an inducement to permit the banks to obtain improper benefits), aiding and abetting breach of fiduciary duty claims based solely on the existence of a so-called “dead hand” change of control default provision in a proffered form of credit agreement should be dismissed.

The banks’ view is supported by the narrower definitions of “knowing participation,” an essential element of an aiding and abetting claim, more recently applied by other members of the Court of Chancery in Lee v Pincus, C.A. No. 8458-CB (Del. Ch. Dec. 11, 2014) and In re Converge C.A. No. 7368-VCP (Del. Ch. Dec. 25, 2014) adjudicating aiding and abetting breach of fiduciary duty claims against an underwriter and an acquiror, respectively. Arguably, the definitions of “knowing participation” applied in those decisions would have resulted in the dismissal of the aiding and abetting breach of fiduciary duty claims against the administrative agent of the credit facility at issue in Healthways.

Healthways

In Healthways, a bench ruling by Vice Chancellor Laster, the Court refused to dismiss an aiding and abetting breach of fiduciary duty claim against the administrative agent of Healthways’ credit facility for including a so-called “dead hand” change of control default provision in an amended credit agreement. The Court of Chancery also refused to dismiss breach of fiduciary duty claims against the board of directors of Healthways for agreeing to the amended credit agreement containing that provision.

Credit agreements and bond indentures often contain a provision that a “change of control” of the borrower will constitute an event of default. Typically a “change of control” will be deemed to occur if, among other things, within a certain period of time (e.g., 12 or 24 months), a majority of the borrower’s directors are not “continuing directors”—i.e., directors who were on the board at the time the credit agreement was signed or who were later appointed or approved by such persons or their appointed or approved successors.

In Kallick v SandRidge Energy, C.A. No. 4446-VCL (Del. Ch. May 12, 2009), an earlier decision by the Court of Chancery, the court interpreted such a provision of the indenture to permit a board to “approve” persons nominated for election to the board by a dissident stockholder, even if the board continued to recommend that the board’s stock be voted in favor of the nominee approved by the dissenting stockholder. Such an approval of potential directors by a fiduciary would, under the same issue of “knowing participation,” provide the essential element of complicity for a person to have caused a “change of control” within the terms of the debt instrument, significantly undermining the protective benefits to the lenders of such provision. See also San Antonio Fire & Police Pension Fund v Amylin. Specifically, “dead hand” provisions prevent persons from being appointed to the board of any such entity as a result of the election of a dissident stockholder’s nominees to the board only if the current board elected the nominees. As a consequence of the Court’s decision in SanRidge, lenders began to more frequently include so-called “dead hand” change of control default provisions in credit agreements. The inclusion of a dead hand change of control default provision preserves the ability of lenders to declare a default in the event of the election of a dissident stockholder’s nominees as a majority of the board of the borrower, regardless of whether the current board ultimately approves the dissident stockholder’s nominees as they did in Amylin and were required to do in SanRidge. See also San Antonio Fire & Police Pension Fund v Amylin. Specifically, “dead hand” provisions require the current board, regardless of whether it is elected by a majority stockholders, to be engaged in a continuous process of either re-nominating new directors or approving persons as successors of directors of the board or (if the credit agreement permits) in the credit agreement by the current board member at the point in time the following language provision contains a “dead hand” provision in both titles of the credit agreement.

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Company cease to be composed of individuals (i) who were members of that board or equivalent governing body on the first day of such period, (ii) whose election or nomination to that board or equivalent governing body was approved by individuals referred to in clause (i) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body or (iii) whose election or nomination to that board or other equivalent governing body was approved by individuals referred to in clauses (i) and (ii) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body (excluding, in the case of both clause (ii) and clause (iii), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any Person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors).

In Healthways, the Court of Chancery found that there was ample precedent from prior decisions of the Court of Chancery (e.g., SandRidge and Amylin) to put lenders on notice that similar “change of control” default provisions in debt instruments were highly suspect and could potentially lead to a breach of duty on the part of the fiduciaries of the borrower negotiating the debt instrument.

The Healthways Court went on to say that:

It is certainly true, and I agree, that evidence of arm’s-length negotiation negates claims of aiding and abetting. In other words, when you are an arm’s-length contractual counterparty, you are permitted, and the law allows you, to negotiate for the best deal that you can get. What it doesn’t allow you to do is to propose terms, insist on terms, demand terms, contemplate terms, incorporate terms that take advantage of a conflict of interest that the fiduciary counterparts on the other side of the negotiating table face.

This is the premise that is true in third-party deal cases. The acquirer is perfectly able to negotiate for the best deal it can get, but as soon as it starts offering side benefits, entrenchment benefits, other types of concepts that create a conflict of interest for the fiduciaries with whom it’s negotiating, that acquirer is now at risk. Is the acquirer necessarily liable? No. But does that take the acquirer out of the privilege that we afford arm’s-length negotiation? It does.

In the wake of the Healthways ruling, numerous copycat lawsuits have been filed against the boards of directors of other companies whose credit agreements contain “dead hand” change of control default provisions and the administrative agents under those credit facilities, and more copycat lawsuits will certainly follow. In effect, it has become a cottage industry. Typically, the plaintiffs’ firms identify Delaware incorporated companies with debt instruments that incorporate a “dead hand” change of control default provision and then file suit seeking to have the default provision declared unenforceable, or in the absence of such a ruling, seeking attorneys’ fees for the corporate benefit achieved on behalf of the borrower.

Significantly, both SandRidge and Amylin related to decisions by the boards of those companies with respect to the approval of director nominees for purposes of the change of control provisions in their bond indentures in the midst of contested director elections. While not adopted in connection with a contested director election, the amended credit agreement containing the dead hand provision at issue

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in *Healthways* was arguably adopted on a "cloudy day"—it was dated as of eight days following the approval by Healthway's stockholders of a precatory resolution calling for the elimination of Healthway's classified board. However, the issue of a "clear" versus a "cloudy" day is more relevant to the question of whether the Healthway's board breached its fiduciary duty, and is significantly less relevant to the question of whether the administrative agent aided and abetted a breach of fiduciary duty by including a provision in the credit agreement that furthers the lenders’ own legitimate interests. In any event, it appears that the copycat complaints relate to credit agreements entered into on a clear day as the only evidence proffered in support of the allegation that the administrative agents aided and abetted a breach of fiduciary duty appears to be that the administrative agent permitted a dead hand change of control default provision to be included in the relevant credit agreement. There are no references in any of the relevant complaints to a subsequent precatory resolution adopted by the Delaware Chancery Court of Chancellor Bouchard in *Healthway v. Bouchard* which may have invalidated the board decision to adopt a "cloudy" day resolution.

While the Delaware Chancery Court was careful to say that it was not invalidating a determination that "dead hand" changes of control default provisions were not a breach, so long as the determination was fashioned by the board in good faith, there remains significant judicial and executive pressure to change the standards that courts will apply in determining whether a resolution that results in a change of control is a "dead hand" change of control provision. At least one local newspaper has reported that several banks have now decided not to include "dead hand" change of control default provisions in their credit agreements pending further legal developments, other banks continue to believe that such provisions remain legitimate and appropriate.

While the Delaware Supreme Court has issued a subsequent decision in *Ironworkers Local No. 25 Pension Fund v. B/E Aerospace*, the Court was careful to say that it was not making a determination that "dead hand" changes of control default provisions were not a breach, so long as the determination was fashioned by the board in good faith, there remains significant judicial and executive pressure to change the standards that courts will apply in determining whether a resolution that results in a change of control is a "dead hand" change of control provision. At least one local newspaper has reported that several banks have now decided not to include "dead hand" change of control default provisions in their credit agreements pending further legal developments, other banks continue to believe that such provisions remain legitimate and appropriate.

**Lee v. Pincus**

In *Lee v. Pincus*, a subsequent decision by Chancellor Bouchard, the Court of Chancery appears to have applied a narrower definition of "knowing participation" than the Court in *Healthways* and granted a motion to dismiss aiding and abetting breach of fiduciary duty claims against underwriter defendants for consenting to the waiver of certain contractual restrictions that had prevented most pre-IPO investors from selling their stock for a designated period of time in a discriminatory manner that benefitted half of the issuer's board of directors. The Court explained that:

"To demonstrate the "knowing participation" element of an aiding and abetting claim, it must be reasonably conceivable from the well-pled allegations that "the third party act[ed] with the knowledge that the conduct advocated or assisted constitute[d] ... a breach [of fiduciary duty]." Knowing participation has been described as a "stringent" standard that "turn[s] on proof of scienter." The alleged aider and abettor, not the fiduciary, must act with scienter. In *In re Telecommunications, Inc. Shareholders Litigation*, the Court provided an instructive summary of some of the ways in which a plaintiff successfully may plead knowing participation:

[K]nowing participation may be inferred where the terms of the transaction are so egregious or the magnitude of side deals is so excessive as to be inherently wrongful. In addition, the Court may infer knowing participation if it appears that the defendant may have used knowledge of the breach to gain a bargaining advantage in the negotiations. The plaintiff's burden of pleading knowing participation may also be met through direct factual allegations supporting a theory that the defendant sought to induce the breach of fiduciary duty, such as through the offer of side payments intended as incentives for the fiduciaries to ignore their duties.

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In my opinion, the allegations of the Amended Complaint do not support a reasonable inference of knowing participation by the Underwriter Defendants. I agree with plaintiff’s assertion that it has failed to plead any facts from which it is reasonably inferable that the Underwriter Defendants knew when they provided their consent to modify the lockup restrictions that such action would facilitate a breach of fiduciary duty by the Director Defendants. The fact that the Underwriter Defendants’ consent was necessary for the Director Defendants to waive a lockup restriction, without more, is insufficient to demonstrate that the Underwriter Defendants gave their consent with the knowledge that the Director Defendants were treating Lee and the putative class unfairly. The fact that the Underwriter Defendants’ consent was necessary for the Director Defendants to waive a lockup restriction, without more, is insufficient to demonstrate that the Underwriter Defendants gave their consent with the knowledge that the Director Defendants were treating Lee and the putative class unfairly.

The Amended Complaint, moreover, does not allege that the amount of fees the Underwriter Defendants received in connection with the secondary offering were unreasonable for the services performed. Thus, there is no well-pled basis to infer that the Underwriter Defendants extracted unreasonable compensation or any form of improper “side deal” for consenting to the selective lockup waivers. In sum, it is not reasonable to infer here that, simply by receiving fees (that are not alleged to be unreasonable) for acting as underwriters in the secondary offering, the Underwriter Defendants “participated in the [Zynga] board’s decisions, conspired with [the] board, or otherwise caused the board to make the decisions at issue. . . .”

I thus conclude that the allegations of knowing participation in the Amended Complaint do not support a reasonable inference of knowing participation by the Underwriter Defendants.

In sum, the allegations of knowing participation in the Amended Complaint do not support a reasonable inference of knowing participation by the Underwriter Defendants. Critically, plaintiff has failed to plead any facts from which it is reasonably inferable that the Underwriter Defendants knew when they provided their consent to modify the lockup restrictions that such action would facilitate a breach of fiduciary duty by the Director Defendants. The fact that the Underwriter Defendants’ consent was necessary for the Director Defendants to waive a lockup restriction, without more, is insufficient to demonstrate that the Underwriter Defendants gave their consent with the knowledge that the Director Defendants were treating Lee and the putative class unfairly.

The Amended Complaint, moreover, does not allege that the amount of fees the Underwriter Defendants received in connection with the secondary offering were unreasonable for the services performed. Thus, there is no well-pled basis to infer that the Underwriter Defendants extracted unreasonable compensation or any form of improper “side deal” for consenting to the selective lockup waivers. In sum, it is not reasonable to infer here that, simply by receiving fees (that are not alleged to be unreasonable) for acting as underwriters in the secondary offering, the Underwriter Defendants “participated in the [Zynga] board’s decisions, conspired with [the] board, or otherwise caused the board to make the decisions at issue. . . .”

Converge

Similarly, in Vice Chancellor Parsons’ subsequent Converge opinion relating to claims arising from Converge’s acquisition by H.I.G. Capital, the Court of Chancery applied a narrower view of the scienter required to establish knowing participation for purposes of an aiding and abetting breach of fiduciary duty claim—appearing to require complicity or misleading behavior by an advisor or the actual inducement of a board to sell out its stockholders by an arms’-length counterparty. According to the Court, hard negotiating for provisions advantageous to an arms’-length counterparty—like a better price, are not actionable unless the arms’-length counterparty induces the board to sell out its stockholders:

Proving liability under an aiding and abetting theory—largely come[s] down to what constitutes “knowing participation.” In at least one case, this Court has suggested that this element of the aiding and abetting test—requires an understanding between the parties—with respect to their complicity in any scheme to defraud or in any breach of fiduciary duties. This Court has also suggested, however, that aiding and abetting liability cannot be established on the mere showing of a subjective understanding of—complicity—between the advisor and the advisor stockholder in a scheme involving the breach of a duty. Delaware courts have held aiding and abetting liability—when a third party is being induced to agree to a breach of fiduciary duty—may exist in the absence of a subjective understanding of—complicity—between the advisor and the advisor stockholder in a scheme involving the breach of a duty. According to the Court, the factual record—point[ed] to evidence of a conflict of interest diverting the advisor’s loyalties from its client, such that the advisor, like the bankers in Del Monte and El Paso, is being paid in some fashion something it would not otherwise earn to make it more attractive.

These cases stand in contrast to many others that have rejected aiding and abetting claims as a matter of law, primarily because in the latter category of cases there was no comparable evidence of an abuse of trust by the third-party aiders-and-abettors vis-à-vis the corporate fiduciaries. The most typical example of such failed aiding and abetting claims is when a third-party acquirer is accused of aiding and abetting fiduciary breaches by the target board. In those situations, this Court has adhered to the rule that—a bidder’s attempts to reduce the sale price through arm’s-length negotiations cannot give rise to liability
A number of commentators have analogized the dead hand change of control default provisions in credit agreements to the dead hand poison pill invalidated by the Delaware Supreme Court in *Quickturn Design Systems v Shapiro*, No. 511 (Del 1998). But, in *Quickturn*, the dead hand poison pill was unilaterally adopted by the Quickturn board despite its potential self-serving entrenchment benefits. In contrast, the dead hand change of control default provision at issue in *Healthways* was proffered by the lenders in order to protect their ability to be repaid in full in the event an insurgent stockholder took control of the Healthways board. Like the underwriters in *Lee v. Pincus*, the administrative agent in *Healthways* was an arm's-length counterparty and could not know the extent to which the Healthways board had considered or approached other sources of financing or the potential ramifications of the dead hand change of control default provision or otherwise fulfilled its fiduciary duties.

Absent collusion or complicity, should an arm's-length counterparty's pursuit of its best interests through hard bargaining over contractual terms subject it to nondismissable aiding and abetting breach of fiduciary duty claims? Consider a greeting card company heavily dependent on a license to use certain cartoon and animated characters in its birthday, holiday and other cards. Should the owner of the rights to use the cartoon and animated characters be potentially liable for aiding and abetting a breach of fiduciary duty if, in an effort to protect its intellectual property, it insists on a dead hand change of control termination right in its intellectual property license agreement with the greeting card company?

The complaints in *Healthways* and in the *Quickturn* case do not have a basis that the dead hand change of control default provision, if ever negotiated before the board members became an actual contract provision, was not intended by the lenders to be conditioned on the Healthways board's adoption of it. Like the underwriters in *Lee v. Pincus*, the administrative agent accused of aiding and abetting the borrower's board by proffering a form of credit agreement that contained a dead hand change of control default provision, *Healthways* was held not to have breached the shareholders' fiduciary duty by negotiating a form of credit agreement that contained a dead hand change of control default provision. However, the underwriters in *Lee v. Pincus* were exonerated when it was shown that the underwriters did not act to protect the shareholders' interests as part of an effort to enhance the underwriters' positions in an impending financial restructuring. The underwriters were not aiding and abetting the violation of the underwriters' fiduciary duties.

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