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CONTENTS

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Ted Mirvis, Wachtell

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Delaware's Future

Ted Mirvis and his charter proposal:

Pro BHNO: Born Here in New Orleans

Five years ago, Wachtell's Ted Mirvis stood in the town square of mergers and acquisitions, Tulane's annual conference in New Orleans, and shouted a warning to the citizens: M&A could no longer assume that the courts of Delaware were safe from challenge as the arbiters of the business. Not only were shareholders challenging deals more often, but, equally disturbing, more of those suits were cropping up in state courts across the country.

At the twenty-fourth Tulane institute this spring, Mr. Mirvis demonstrated that both prongs of the problem now have thousands of tentacles. The number of suits has spiked as has the proportion of those brought outside Delaware. The average number of lawsuits per deal, for those transactions worth a minimum of $500 million, is now 6.1. In 2010, a mere fifty suits out of a total of 196 were filed exclusively in Delaware. "It's really getting quite serious," Mr. Mirvis.

All is not lost. One hundred and ninety-five Delaware companies have turned to the solution Mr. Mirvis suggested five years ago. We now turn to Mr. Mirvis himself.

Mr. Mivis: I can go very fast. I'll just leave out the jokes.

Eileen Nugent (Skadden): We want the jokes!

Mr. Mirvis: I'm going to talk about multi-jurisdictional litigation issues in deals. It's been five years since I first whined about this subject here in New Orleans on this stage at Tulane, and the recent article published by Claudia Allen which is a fascinating overview of where we are on this subject. There are now two hundred Delaware companies, as of the end of year, including twenty-seven out of the S&P 500, that have adopted exclusive forum selection clauses. These are in charters or bylaws. I refer to these now as Pro BHNO—Born Here in New Orleans.

What's the problem? I think we all know the problem. The problem is that it is now the norm in deal cases that there are multiple

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"Remember to round each billable hour off to the nearest week."

Mirvis

continued

suits with overlapping claims in multiple forums. The volume of deal cases has absolutely spiked, as Vice Chancellor Laster mentioned this morning. In 2007, when we first talked about this, there were 195 deals over five hundred million. In 2010, there were 108 deals over five hundred million, yet the number of litigations virtually tripled. Over ninety percent of deals valued at over a hundred million dollars attract stockholder litigation. The average number of lawsuits per deal in 2011 for deals of five hundred million or more is 6.1. Six point one lawsuits per deal. Six point one. It's kind of like the ratio of gin to vermouth—I mean, it's really getting quite serious.

James Morphy: That's a little heavy on the vermouth.

Ted Mirvis: See, I knew Jim would get it. That *was* reversed. [laughter]. One other data point: M&A state class action filings now outnumber—there are more of them—than federal securities class action filings. They have become the lawsuit of choice. There is a fascinating article by Jennifer Johnson. It has an enormous quantity of data on this subject.

This is not only a Delaware phenomenon. Nevada, New York, California and Maryland, among other states of incorporation, have also seen the same thing. Deals by companies I those states have attracted shareholder litigation both in the home state of the company and in a foreign jurisdiction. Double click on Delaware: in 2010, there were 196 M&A class actions; only in fifty examples were there Delaware-only examples, and there only 38 non-Delaware cases, and in 108 there were multi-jurisdictional filings. Two-thirds of cases about Delaware companies—two thirds of those cases—are filed outside of Delaware. Forty-eight percent were in other states, only forty-one percent were in Delaware's Court of Chancery, and eleven percent were in Federal court.

Why is it happening? Is it just Willie Sutton—people rob banks because that's where the money is. I'll just point out a couple of things that I think are interesting. Someone said that Delaware case law was responsible because it suggested that its courts would take seriously concepts of ripeness, justiciability, gun-jumping, and would police the conduct of lead plaintiffs' council, et cetera. Some of these issues were brought to the fore in the Nighthawk decision. But to me the only real solution to this is going to be in forum selection bylaws. We don't want Delaware judges to take stupid pills, and to allow things to happen that shouldn't happen because otherwise cases would be brought outside of Delaware. The plaintiffs bar will bring cases outside of Delaware if it's to their advantage—and to the advantage of their clients—I don't want to categorize this as an overly cynical idea.

Some of the other causes I think include: there is clearly increased competition and fragmentation in the plaintiffs bar compared to ten years ago. There was a big whale in the system that could control everybody. That doesn't exist any more. Business courts have cropped up in other states. I remember twenty years ago if you got sued by stockholders outside of Delaware you'd laugh because the plaintiff would file a motion for expedited discovery and they would hear nothing back from the court and four weeks later the court would say, "Okay, we'll put it down for a status conference"—in another four weeks. Now, there are courts that move very quickly in other states.

But I think the real reason is the plaintiff's bar clearly perceived a higher beta/volatility in non-Delaware forums. And that increases the value of the cases. Plaintiffs thrive on uncertainty, as Steve Lamb and Bob Schumer wrote in an article recently, with an expert posted recently on the Harvard Law School Forum. Why do we care about it? I think that's relatively clear. Two things: One reason we should care about it, as a system, is because it does create a risk of defendant-side settlement forum shopping and the possibility of a reverse auction. Academics have written about the possible impact on law development. I haven't seen it. I don't know of any decision on Delaware law by a non-Delaware court that has created any issue about the development of the law. As a matter of fact, I think I can say I haven't really seen a decision on Delaware law by a non-Delaware court.

So, the question is what to do about it. There is no app for it. Obviously the old fashioned thing was to move to stay in the disfavored forum. That obviously has consequences from a litigation point of view. You're telling a judge you want a different judge.

I'd like to point out an interesting decision on March 5 by Vice Chancellor Glassock in a case called Dias versus Purches, where the Delaware court refused to stay a merger case brought in Chancery even though it had gotten beaten by other plaintiffs in a Florida case by about a month. I'd like to view that case where Delaware is kind of putting its stake down and saying: Delaware issues at Delaware corporations involving deals ought to be decided in Delaware courts. The holding in that case in one sentence, quoting L.P. Hartley in The Go-Between: "The past is a foreign country: they do things differently there." I'll have to leave understanding that to another panel.

One technique that has arisen recently is the single forum motion, which was referred to in one decision by the former chancellor as the Savitt Motion, because my partner Bill Savitt has his name on the first one. It's a simple technique where if you have parallel cases—you can even have three cases—you file the exact same papers (you have to change captions: it can be a little tricky) but you file the same papers in the same courts at the same time, basically saying to the judge: "Look, we're happy to litigate wherever you want. Really, we think it should be in Delaware, but we're happy to litigate wherever you want, but what we don't want to do is litigate in two places at once."

That has had some success—and here you see a quote from Chancellor Chandler saying that he considered that to be one, if the most, efficient and pragmatic method to deal with the problem. This has been used in at least sixteen cases, with eleven different parallel jurisdictions.

But now we come to the main act, which is the charter provision. This is just model language that I've provided on the slides. There are many forms. There is a little bit of breaking news: the Empire has struck back. As I said, over 200 Delaware companies have these. There was a series of litigations filed in Chancery, all in relatively close order in January and February, challenging the legality of these provisions under Delaware law. Not the question which will always be true: will the second court defer to the existence of an exclusive provision like this, whether it's in a bylaw or a charter. All the cases in Delaware that involve a challenge to bylaws have a theme, which I must say I thought—well, I'll aside the cynicism. They allege that directors who adopt bylaws choosing Delaware as the exclusive forum for litigating claims of breach of fiduciary duty and other claims, engage in a self-interested decision subject to entire fairness review.

That to me—well, I know the case is *sub judice* so I won't belabor it, but make that point to the CEOs of El Paso, Delphi, Del Monte and see if they agree.

* * *

And here is an edited version of what Mr. Mirvis showed on the screen at Tulane. "Everything I know about this subject is in the slides," he said. And so we present them in full, except for the "ching ching' sound effect from Pink Floyd's Dark Side of the Moon.

Mirvis ➔

Multi-jurisdictional Issues in Stockholder / Deal Litigation

Theodore N. Mirvis
WACHTELL, LIPTON, ROSEN & KATZ

2012 CONFERENCE OF CHIEF JUSTICES
Midyear Meeting
Wilmington, DE

What is the problem?

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What is the problem?

- Every corporation in an M&A transaction is subject to suit in at least two venues:
  - State of incorporation
  - Principal place of business
- The stockholder state law fiduciary attack on the target/selling corporation's directors can be transformed or coupled with disclosure claims (under either/both state and federal law)
- Multi-jurisdictional stockholder class action challenges to M&A transactions – multiple suits, multiple claims, multiple forums – is now "the new normal"

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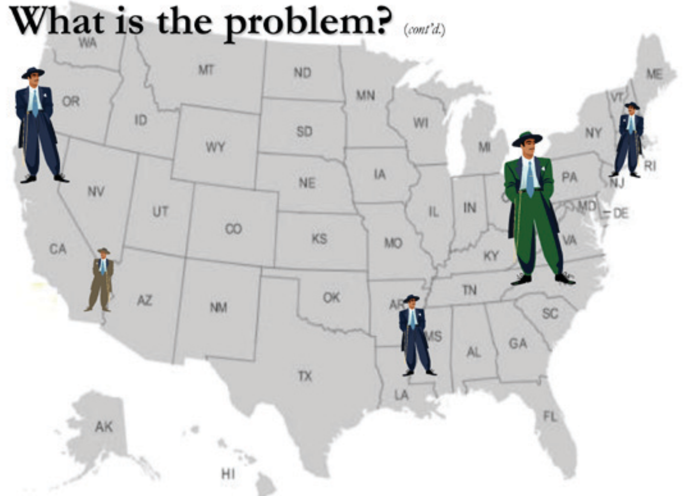
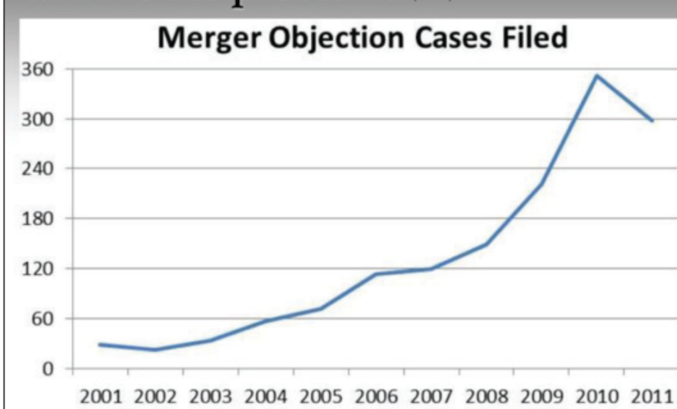
What is the problem? *(cont'd.)*



What is the problem? *(cont'd.)*



* Advisen Ltd., 2011.

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What is the problem? *(cont'd.)*

- **M&A state court class actions now outnumber federal securities class action filings – and *"have replaced traditional stock drop cases as the lawsuit of choice for plaintiffs securities lawyers."**** *
  - Typically considered the result of SLUSA and CAFA
  - In 2010, each M&A event spurred an average of 1.8 filings
  - "The relative percentage of Delaware cases as opposed to those in other jurisdictions has fallen."**

* Jennifer Johnson, Securities Class Actions in State Court (2011), University of Cincinnati Law Review, Forthcoming; Lewis & Clark Law School Legal Studies Research Paper No. 2011-17, *available at*: http://ssrn.com/abstract-1856695, at 51.

** John Armour, Bernard S. Black & Brian R. Cheffins, *Is Delaware Losing Its Cases?* (University Of Cambridge Faculty Of Law Research Paper No. 11/08, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id-1578404

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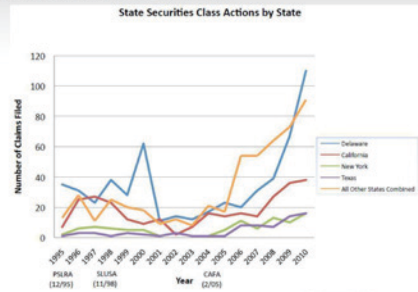
What is the problem? *(cont'd.)*

- **"[T]he largest number of state securities class action filings occur in Delaware, followed by California, New York and Texas" - a function of incorporation, headquarters, or at least doing business.***



* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 27.

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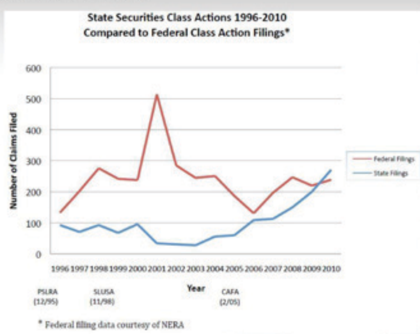
What is the problem? *(cont'd.)*

- **"[B]y 2010, the number of securities class action filings in state court outnumbered federal filings."***



* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 26. "Securities Class Actions" are defined as class claims "relating to the purchase, sale, or ownership of securities, including fiduciary duties, in connection with mergers and acquisitions" (*id.*, at 23).

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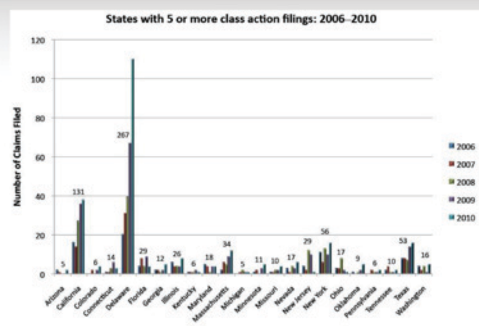
What is the problem? *(cont'd.)*

- **In 2006-2010, 23 states had 5 or more securities class action filings, as compared with 8 states in 2001-2005.***



* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 30.

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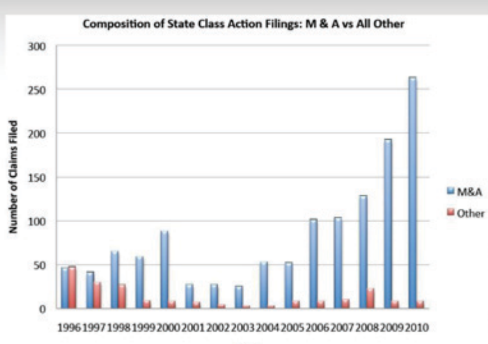
What is the problem? *(cont'd.)*

- **M&A is now the dominant subset of state securities class action filings*…**



* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 34.

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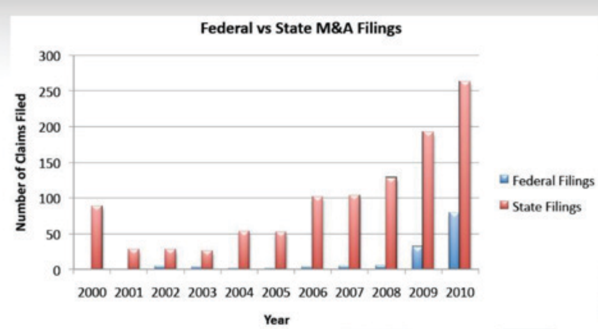
What is the problem? *(cont'd.)*

- **… and state court M&A class action filings far exceed federal court filings.***



* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 36.

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What is the problem? *(cont'd.)*

- **[I]ncreasingly, plaintiffs' attorneys are choosing to file cases outside of the state of incorporation."***
  - Not only a Delaware phenomenon
  - Data is consistent with LBO and M&A cases studied in John Armour, Bernard S. Black & Brian Cheffins' "Is Delaware Losing its Cases?"** and "Delaware's Balancing Act"***

Filings by State of Incorporation (2010)

	State of Incorporation of all defendants	State of Incorporation subset: M & A defendants	Home State Court Filing	Federal Court Filing	Other State filing
Delaware	196	193	103	47	115
Nevada	12	11	6	6	6
New York	6	5	4	3	2
California	5	5	4	3	1
Maryland	5	5	3	1	2
Other	38	3	26		12

* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 37.
** John Armour, Bernard S. Black & Brian R. Cheffins, "*Is Delaware Losing its Cases?*" (University of Cambridge Faculty of Law Research Paper No. 11/08, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id-1578404.
*** John Armour, Bernard S. Black & Brian R. Cheffins, "*Delaware's Balancing Act*" (Oxford Legal Studies Research aper No. 64/2010), *available at* http://ssrn.com/abstract_id=1677400.

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What is the problem? *(cont'd.)*

- **"[A]ny one M&A event is likely to induce multiple filings."***
  - Delaware corporations in 2010 – of 196 M&A Class actions:
    - 50 Delaware only
    - 38 single non-Delaware filings
    - 108 multi-jurisdictional filings

2010 State Class Action Filings Against Delaware Corporations & Federal Tag Alongs

	Triggering Events	Class Action Complaints Filed		
		State	Federal	Total Filings
M & A	192	280	71	351
Other	7	7		7
Total	199	387	71	358

* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 39.

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Why does this happen?

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Why does this happen?

A "Perfect Storm" of pressures/incentives:

- **PSLRA, SLUSA and CAFA made federal securities cases more challenging**
  - Data suggests that "dispossessed plaintiffs' lawyers increasingly have turned to filing alternative class actions in state court."*
- **SLUSA and CAFA mainly relegate state securities class actions to claims involving corporate governance or M&A based on law of state of incorporation (the SLUSA "Delaware Carve-Out")**
- **Delaware case law suggested its courts would enforce concepts of ripeness/justiciability to dismiss "gun-jumping" filings,** police selection/conduct of lead plaintiffs' counsel,*** and cut fees in weak/nonmeritorious suits**
  - "It's not surprising that . . . entrepreneurial plaintiffs' lawyers rationally responded to that by increasing the frequency with which they file elsewhere."****

* Jennifer Johnson, *"Securities Class Action Lawsuits in State Court"* (2011), at 3.
** *In re Cox Commc'n S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005).
*** E.g. *In re Revlon S'holders Litig.*, 990 A.2d 940 (Del. Ch. 2010)(describing multi-forum filings and typical sequence as a "Kabuki Dance" and removing lead counsel); *King v. VeriFone Holdings, Inc.*, 994 A.2d 354 (Del. Ch. 2010)(critical of "lead counsel Olympics race"); *In re Topps Co. S'holders Litig.*, 924 A.2d 951 (Del. Ch. 2007)("unseemly filing Olympiad").
*****Scully v. Nighthawk Radiology Holdings, Inc.*, C.A. No. 5890-VCL, Transcript at pp. 18-19 (Del. Ch. Dec. 17, 2010).

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Why does this happen?

A "Perfect Storm" of pressures/incentives (cont'd.):

- **Plaintiffs' bar has expanded capacity/resources after the Enron/Worldcom scandal period**
- **Increased competitiveness/fragmentation of plaintiffs' bar inter se (an unintended consequence of PSLRA?)**
- **Multi-jurisdictional litigation by definition creates more "seats at the table"***
- **Emergence of business courts in other states offered accessibility/responsiveness to expedited cases**
- **Plaintiffs' bar perceived higher beta/volatility of result in non-Delaware forums → increasing settlement value**
- **In LBO/private equity takeout cases, principal place of business may be a hospitable forum (effect on employee/community stakeholders)**

* *In re Compellant Techs., Inc. S'holder Litig.*, C.A. No. 6080-VCL, Transcript at 20 (Del. Ch. Jan. 13, 2011); *In re Burlington N. Santa Fe S'holder Litig.*, C.A. No. 5043-VCL, slip op. at 34 (Del. Ch. Oct. 28, 2010).

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Why care?

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Why care?

- **Waste and Duplication** – especially in expedited proceedings
- **Risk of inconsistency in law application**
  - "…which would then leave the law in a confused state and pose full faith and credit problems for all involved."*
  - Includes discovery/privilege issues
- **Risk of plaintiff-side competition producing unwarranted/inefficient litigation steps (e.g., TRO applications, super-expedition)**
- **Risk of defendant-side "settlement forum shopping" – possibility of a "reverse auction"****
- **Possible impact on law development**
- **Possibility of externality costs increasing settlement value**
  - Encourages objections to settlement (or requires a "tax" to the other jurisdiction's plaintiff-counsel)

* *In re Allion Healthcare Inc. S'holders Litig.*, 2011 WL 1135016, at *4 (Del. Ch. Mar. 29, 2011).
** *See Prezant v. De Angelis*, 636 A.2d 915, 922 (Del. 1994); *Scully v. Nighthawk Radiology Holdings, Inc.*, Del. Ch. C.A. No. 5890-VCL (Report of Special Counsel Gregory P. Williams) (also noting that "forum shopping" can be "unquestionably proper"). *See generally* John. C. Coffee, Jr. "*Class Wars: the Dilemma of the Mass Tort Class Action*," 95 Colum. L. Rev. 1343 (1995).

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What to do?

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What to do?

- **Motion to stay by defendants in one (disfavored) forum**
  - but "collateral consequences"*
- **SLUSA and the "Delaware Carve-Out"**
  - but has not been held to limit state court jurisdiction to state of incorporation**

* *Continuum Cap.* v. Nolan, C.A. No. 5687-VCL, at 87 (Del. Ch., Feb. 3, 2011).
** *Pace v. Bidzos*, 2007 WL 2908283, at *2 (N.D. Cal. Oct. 3, 2007) ("[T]he court finds no support in the statute for defendants' claim that the Delaware carve-out applies only to cases brought in the state courts of the state of incorporation."); *Rubery v. Radian Group*, 2007 WL 1575211, at *4 (E.D. Pa. May 31, 2007) ("The absence of a venue provision in SLUSA . . . demonstrates that Congress chose not to restrict venue."; *Gibson v. PS Group Holdings, Inc.*, 2000 WP 777818, at *6 (S.D. Cal. Mar. 8, 2000) ("The Court . . . finds the language of the Delaware carve-out unambiguous as to its lack of a venue restriction, and declines to give legal effect to unenacted statements in the legislative history.").

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What to do? *(cont'd.)*

- **"Single Forum" motion by defendants in both/all courts (the "Savitt Motion"*)**
  - "My personal preferred approach … is for defense counsel to file motions in both (or however many) jurisdictions where plaintiffs have filed suit, explicitly asking the judges in each jurisdiction to confer with one another and agree upon where the case should go forward. . . . [T]his would be, I think, one (if not the most) efficient and pragmatic method to deal with this increasing problem. It is a method that has worked for me in every instance when it was tried." [*In Re Allion Healthcare, Inc. S'holders Litig.*, C.A. 5022-CC (March 29, 2011), fn 12.]
  - "Single Forum" motions have been filed in at least sixteen Delaware cases – with eleven different parallel jurisdictions

California, Connecticut, Georgia, Illinois, New Jersey, New York, Oklahoma, Pennsylvania, Texas, Washington, West Virginia**

* *Nierenberg v. CKx, Inc.*, C.A. No. 5545-CC (Del. Ch. May 27, 2011) (Letter op.).
** C. Barr and Kathaleen St. J. McCormick, "*The Delaware Court of Chancery Endorses the Forum Motion as a Solution to Multi-Jurisdictional Litigation*" (Fall 2011).

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What to do? *(cont'd.)*

- **Charter/Bylaw Exclusive Forum Provision***

Model Charter Language:

The Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) **any derivative action** or proceeding brought on behalf of the Corporation, (ii) any action asserting a **claim of breach of a fiduciary duty** owed by any director or officer of the Corporation to the Corporation or the Corporation's stockholders, creditors or other constituents, (iii) any action asserting a claim against the Corporation or any director or officer of the Corporation arising pursuant to any provision of the **Delaware General Corporation Law or the Corporation's Restated Certificate of Incorporation or By-Laws** (as either may be amended from time to time), or (iv) any action asserting a claim against the Corporation or any director or officer of the Corporation governed by **the internal affairs doctrine**; **provided**, **that**, if and only if the Court of Chancery of the State of Delaware dismisses any such action for lack of subject matter jurisdiction, such action may be brought in another state court sitting in the State of Delaware.

* See "*Anywhere But Chancery: Ted Mirvis Sounds an Alarm and Suggests Some Solutions*," M&A J. (May 2007) (first proposal of charter exclusive forum provision); *see also* Sara Lewis, "*Transforming the 'Anywhere but Chancery' Problem into the 'Nowhere but Chancery' Solution*, 14 Stan. J. Law Bus. & Fin. 199 (2008) (supporting enforceability of forum-selection provision); *see also* Elizabeth Bennett, "A Great Migration of M&A Cases Out of Delaware," Del. Bus. Ct. Insider (Mar. 16, 2011).

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What to do? *(cont'd.)*

- ***"If boards of directors and stockholders believe that a particular forum would provide an efficient and value promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."*** [*In Re Revlon*, 990 A.2d 940 (Del. Ch. 2010)]*
- **82 Delaware corporations have adopted forum selection provisions as of 2011**
- **Vast majority with charter provisions were implemented without a stockholder vote (at IPO stage)**
  - Roughly half in charter and half in bylaws
  - 39% have California principal place of business
  - Includes Berkshire Hathaway, Chevron, Fed Ex, LinkedIn, Oracle
  - Similar provisions have been adopted by Nevada and Maryland corporations**
- **In 2011 proxy season, 4 of 5 companies successfully enacted charter amendments**

* Cf. Paul D. Weitzel, "The End of Shareholder Litigation: Using Bylaw as Charter Amendments to Require Binding Arbitration of Shareholder Disputes" (2011), *available at*: http://ssrn.com/abstract-1963498.
** Claudia H. Allen, "Study of Delaware Forum Selection in Charters and Bylows (last updated Apr. 7, 2011), *available at*: http://www.ngelaw.com/files/upload/Exclusive_Forum_Provisions_Study_4_7_11_PDF.pdf

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Mirvis →

What to do? *(cont'd)*

- **ISS 2012 Update of its U.S. Corporate Governance Policy*:**
  - Shifted from an "against" recommendation (unless the company had no staggered board, majority vote standard in director elections, right of stockholders to call a special meeting, and no board-adopted poison pill), to . . .
  - "Case-by-case" approach, taking into account:
    - "whether the company has been materially harmed by shareholder litigation outside its jurisdiction of incorporation, based on disclosure in the company's proxy statement" and
    - "good governance features" (no staggered board, majority vote standard, no board-adopted poison pill)
  - ISS noted that at a November 2011 roundtable, institutional investors had no uniform approach, with some investors supporting exclusive venue proposals

* ISS Governance "2012 US Corporate Governance Policy Updates," *available at*: www.issgovernance.com/files/ISS_2012US_Updates20111117.pdf

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What to do? *(cont'd)*

- **ISS 2012 Update of its U.S. Corporate Governance Policy** *(cont'd.)*
  - ISS' statement on the proposal at Allstate in April 2011 (which failed):

    ". . . [T]here are only scant data available quantifying the aggregated impact of out-of-state or parallel shareholder litigation affecting issuers generally.

    "There is merit to the notion that Delaware judges should be the ones to apply Delaware law to Delaware companies, given their expertise and intimate familiarity with the state's body of corporate law. . . .

    "Another consideration is that a company generally has two types of shareholders (although not without overlap): those that bring the types of claims targeted by this proposal, and those that do not. The latter group may benefit from an exclusive venue proposal because it is designed in part to reduce the company's litigation costs."

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What to do? *(cont'd)*

- **One court has declined to enforce a forum selection bylaw adopted by board of directors after the conduct challenged in a suit brought by a stockholder who had acquired shares prior to adoption of the bylaw.**
  - *Galaviz* v. *Berg*, 763 F. Supp. 2d 1170 (N.D. Cal. 2011) (applying federal common law and noting that court would not "defer to any provision of state corporate law that might purport to give a corporation's directors the power to control venue")
- **Option to Select an Alternative Forum**
  - Allows corporate defendant to elect to proceed in alternative forum
  - Becoming more common than mandatory provisions

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What to do? *(cont'd)*

- **Possible Federal Legislative Response?***
  - Repeal the SLUSA "Delaware Carve-out"
    → Forces cases into federal court subject to PSLRA pleading and lead plaintiff provisions
  - Restrict the SLUSA "Delaware Carve-out" to suits filed in the courts of the corporation's state-of-incorporation (as the legislative history indicates was the SLUSA intent
- **Possible State Legislative Response?**
  - Cf. former proposed Uniform Transfer of Litigation Act § 201, 14 U.L.A. 677 (1991)
  - Uniform or unilateral adoption by statute of exclusive venue provisions for state-created claims?

* Jennifer Johnson, "*Securities Class Action Lawsuits in State Court*" (2011), at 53.

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What to do? *(cont'd)*

- **Suggestions of "Best Practices" from the Special Counsel report in multi-jurisdictional litigation in the *Nighthawk** case:**
  - "[B]est practice for counsel negotiating a settlement of [multi-jurisdictional deal] litigation in a jurisdiction outside of Delaware – recognizing [the Delaware Court of Chancery's] focus on representative settlements – would be to substantially involve Delaware counsel in the negotiations."
  - "[T]he non-settlement forum should ensure that all courts involved in the multi-jurisdictional case are operating on the same information."

* Scully v. *Nighthawk Radiology Holdings, Inc.*, C.A. No. 5890-VCL (Del. Ch. Mar. 11, 2011) (Report of Special Counsel Gregory P. Williams), at pp. 30, 34-35.

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What to do? *(cont'd)*

- **Suggestions of "Best Practices"** ***(cont'd.)*****:**
  - "[T]he parties have a heightened obligation to provide information to all courts involved when rulings have been made on the merits."
  - ". . . The non-settlement forum could request from the common parties (again, likely the defendants) contact information for the judge presiding over the settlement action, and vice versa. In that way, both courts could play a more active role, if necessary, in ensuring that the proposed settlement is reviewed on a full record and on complete information."
- **Cf. ABA House of Delegates adoption in August 2011 of the "Protocol on Court-to-Court Communications in Canada-U.S. Cross-Border Class Actions"***

* ABA Section of Litigation Report to the House of Delegates (Aug. 2011), *available at*: http://www.abanow.org/2011/07/2011am101c

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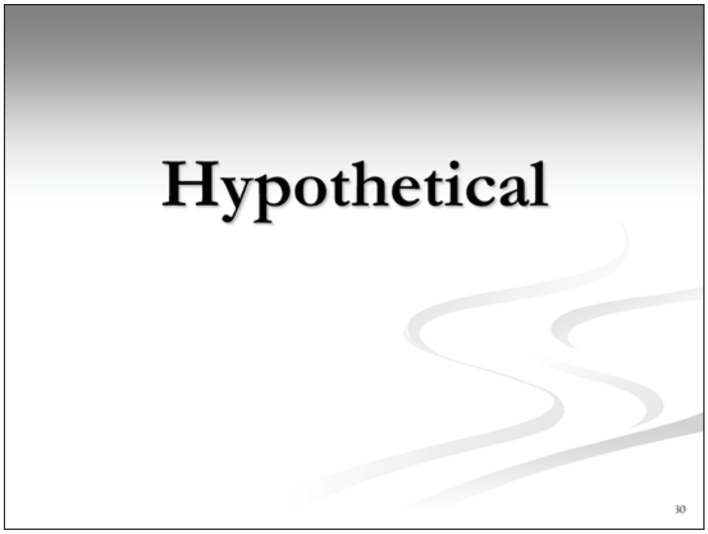
Hypothetical
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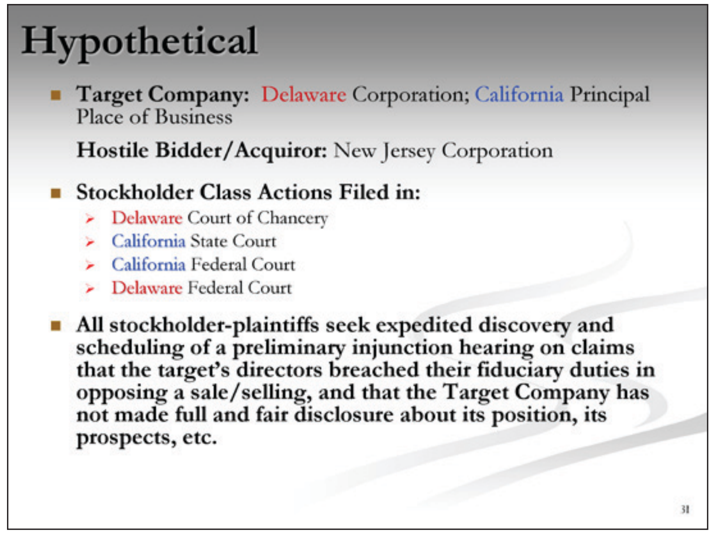
Hypothetical
Target Company: Delaware Corporation; California Principal Place of Business
Hostile Bidder/Acquiror: New Jersey Corporation
Stockholder Class Actions Filed in:
Delaware Court of Chancery
California State Court
California Federal Court
Delaware Federal Court
All stockholder-plaintiffs seek expedited discovery and scheduling of a preliminary injunction hearing on claims that the target's directors breached their fiduciary duties in opposing a sale/selling, and that the Target Company has not made full and fair disclosure about its position, its prospects, etc.
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Financing a Hostile Tender Offer – Dual Track Commitments

By Pierre Maugüé

2011 saw the launch of some prominent hostile tender offers for large publicly traded U.S. corporations. For instance, in December, Martin Marietta Materials began a hostile $4.8 billion bid for its rival, Vulcan Materials. Earlier, in July, International Paper Company launched a $3.3 billion tender offer for all outstanding shares of Temple-Inland Inc. As the legal and finance community searches for signs of life in the market for mergers and acquisitions, one question may be whether 2012 will see more hostile tender offers. The answer may well depend on whether financing is available to support potential transactions.

The financing structure for a debt-financed hostile tender may vary depending on whether or not the offer is structured to permit a short-form merger to be made immediately after the closing of the tender offer, which would allow the bidder to have access to the target's assets and earnings to support the financing immediately after the closing of the tender. That would be the case if the tender offer is conditioned on the bidder's ending up owning enough shares to effect a short-form squeeze-out merger without a target shareholder vote—typically 90%. Conditioning the offer on reaching 90%, however, could significantly impair the likelihood of success of a bid. Most hostile tender offers therefore are conditioned on the bidder's reaching an ownership level sufficient to ensure that it can effect a long-form merger – typically, but not always, a majority. This creates the possibility that the bidder may acquire less than the percentage required for a short form merger. While the bidder and its financing parties typically expect the back-end merger to close as soon as practicable following the consummation of the tender, it may take several months to do so if a long-form merger is required. The financing supporting the offer (to the extent it does not solely rely on the assets and earnings of the bidder) must therefore anticipate that the transaction will close in two separate steps with the target continuing to exist as a subsidiary of the bidder with publicly traded shares during the period of time between the consummation of the tender and the closing of the back-end merger.

In addition, a bidder that launches a hostile tender offer is usually seeking to negotiate a friendly acquisition. Financing commitments supporting the offer must therefore be structured to offer sufficient flexibility to enable the bidder to negotiate a merger agreement with the target on short notice. With that in mind, to support a debt-financed hostile tender, a bidder commonly will enter into dual track financing commitments which contemplate that the financing can be obtained either if the transaction closes as a hostile tender offer (i.e., a two-step transaction) or the parties enter into a merger agreement (in which case, the transaction is typically described as a one-step transaction).

This article reviews some of the financing considerations relevant to the negotiation of dual track commitments. It also discusses the complications resulting from the need to comply with the rules of the Federal Reserve System's Board of Governors ("FRB") which regulate the amount of credit that may be used in transactions in which margin stock is directly or indirectly offered as collateral for acquisition debt.

PART I – CONSIDERATIONS SPECIFIC TO A TWO-STEP TRANSACTION

(i) Structural Considerations

A distinctive feature of a two-step tender offer is the potential inability to access the credit of the target to finance the transaction between the consummation of the tender and the closing of the back-end merger. A bidder reaching less than 90% ownership cannot use its control over the target's board to cause the target to guarantee its financing because doing so would unfairly disadvantage the minority shareholders of the target. If the financing is committed or syndicated based on the combined credit of the bidder and the target, the financing parties typically want to identify all possible impediments to the ability to close the back-end merger as soon as possible following the consummation of the tender. One obvious problem would arise if the bidder might acquire less than the number of shares of the target necessary to control the target. Therefore, the availability of the financing is usually conditioned upon the acquisition of at least the number of shares needed to effect a long-form merger – typically, a majority of the outstanding shares of the target on a fully diluted basis (the "Minimum Tender Condition"). In addition, the financing parties want to ensure that the tender is conditioned upon appropriate steps being taken to remove obstacles to the transaction such as poison pills and state anti-takeover statutes. In this respect, the interests of the financing parties and the bidder are aligned. Similar to a closing condition in any financing for a one-step merger, financing commitments for a two-step tender typically contemplate that tender offer documents have to be reviewed and approved by the financing parties and provide that, without the prior consent of the arrangers, there can be no amendment, modification, waiver or consent under the tender offer documents that is materially adverse to the interest of the arrangers and the lenders.

The two-step tender offer also creates two separate financing events: (i) the consummation of the tender and (ii) the closing of the back-end merger. The first step has two consequences from a financing point of view: (x) the bidder needs to pay for the shares of the target tendered in the offer and (y) the acquisition of target shares sufficient to satisfy the Minimum Tender Condition will most likely result in a change of control under the target's existing financing arrangements, which may require some or all of its debt to be refinanced. Because of the potential delay between the closing of the tender offer and the closing of the back-end merger, an important consideration is whether the bidder needs to draw all of the financing when the tender closes or whether the financing will incorporate a delayed draw feature with a portion of the funding available to be drawn when the back-end merger closes. Upfront funding eliminates the risk that something goes wrong with the closing of the delayed draw portion of the financing, but it may be expensive as the bidder needs to pay the full interest rate margin for funds that the financing parties typically require be kept in an escrow account until the closing of the back-end merger. However, the relative incremental cost of an upfront funding arrangement is less than the full margin as ticking fees would typically be payable in connection with a delayed draw arrangement.

Finally, the bidder's financing commitments need to be flexible enough to anticipate and permit the arrangements pursuant to which the bidder intends to provide financing to the target to refinance debt upon the occurrence of the change of control, and the target's own financing agreements will need to be reviewed to confirm they permit the new financing to the extent those agreements will remain in effect. For instance, any loans to the target will be both an investment in a non-guarantor subsidiary (from the point of view of the bidder), indebtedness to a third party (from the point of view of the target) and an affiliate transaction. If the target has outstanding bonds with a change of control put, the bidder will need to be able to draw on the financing (or release funds from escrow if the financing was funded in escrow at the consummation of the tender offer) when the change of control put closes, which may be between the consummation of the tender offer and the closing of the back-end merger.

(ii) Additional Considerations Resulting from the Absence of a Merger Agreement

In a hostile transaction, where there is no agreement between the parties, the target is not obligated to assist the bidder with its financing arrangements. As a result, financing commitment papers typically contemplate that, in a two-step tender structure, the obligation of the bidder to cause the target to cooperate with the syndication of the financing does not become effective until the consummation of the tender (at which point the bidder will acquire control of the target). The same applies to the clear market condition, which typically does not restrict debt facilities of the target until the consummation of the tender.

In addition, in a hostile transaction, the bidder does not have access to nonpublic information about a target, such as would be provided in a negotiated acquisition through a due diligence data room. This lack of access limits the bidder's ability to comply with customary obligations to provide the financing parties with target related information, including financial information and projections, to be included in the confidential offering memorandum, as well as its ability to

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make customary representations with respect to target related information.

Financing commitments for hostile tender offers often address these issues by adding an acknowledgment from the financing parties that, prior to the consummation of the tender, information available to the bidder with respect to the target is limited to publicly available information. The financing parties further acknowledge that the bidder will not be deemed to be in breach of its agreements, or any other obligation to provide information or assist with respect to syndication, on account of such limitation.

PART II – ANTICIPATING THE CONVERSION TO A ONE-STEP TRANSACTION

As noted above, financing commitments for hostile tender offers often contemplate a dual track structure anticipating that the financing will continue to be available if a tender offer that starts as a hostile transaction turns into a friendly deal. In a financing for a negotiated acquisition, it is market for the arrangers to have the right to review and be reasonably satisfied with the acquisition agreement. The same applies in dual track financing commitments and, when a hostile tender offer turns friendly, the bidder will typically need to coordinate the review of the merger agreement with its lenders. Because these negotiations are often very confidential and very fast-paced, the parties need to limit the universe of parties that have the right to approve the merger agreement. In addition, months may pass before a hostile tender offer turns friendly. By then, the initial syndication of the financing commitments may have been completed. The bidder and the arrangers therefore need to consider whether additional committed lenders coming in through the first round syndication or additional syndicate members should have the right to approve the merger agreement. Preferably, only the lead arrangers will have such a right.

Acquisition financing commitments typically include a closing condition as to the absence of a target material adverse effect. This condition tracks the parallel condition included in the acquisition agreement and the acquiror often wants the law that governs the determination of a target material adverse effect under the acquisition agreement to also govern the same determination under the financing commitments. In an acquisition agreement, the target material adverse effect definition is often heavily negotiated and includes numerous exceptions. The definition in a tender offer statement is usually much shorter and more broadly drafted. When financing commitments are negotiated in anticipation of the launch of a tender offer, the only definition to work from is the one expected to be included in the tender offer statement, i.e., a broad concept arguably resulting in more conditionality than the definition that will be used in a negotiated merger agreement. When the deal turns friendly, the bidder would need to amend the financing commitments to conform the definition of target material adverse effect to the definition in the merger agreement, in order to avoid being subject to more conditionality than under its merger agreement. Interestingly, one recent set of financing papers for a dual-track transaction contemplated that upon execution of a merger agreement the target material adverse effect definition would be automatically replaced by the corresponding definition in the merger agreement – so long as the arranger was afforded a reasonable opportunity to review and comment on, and was reasonably satisfied with, the definition.[1]

PART III – THE ADDED COMPLEXITY OF THE MARGIN RULES

Regulation U prohibits lenders from "extend[ing] any purpose credit, secured directly or indirectly by margin stock, in an amount that exceeds the maximum loan value of the collateral securing the credit."[2] Margin stock includes any equity security registered on a national securities exchange.[3] Therefore, in a tender offer, the stock of the target constitutes margin stock until the closing of the back-end merger at which point the stock will be delisted. In addition, most financings available to finance an acquisition constitute "purpose credit", defined as "any credit for the purpose, whether immediate, incidental or ultimate, of buying or carrying margin stock."[4] Thus, a financing in

1. Commitment Letter from Wells Fargo Bank, Nat'l Bank Ass'n and Wells Fargo Sec., LLC to ACI Worldwide, Inc (Aug. 29, 2011), available at http://edgar.sec.gov/Archives/edgar/data/935036/000095012311081236/c66029exv99wb.htm (hereinafter ACI Commitment) for the acquisition of S1 Corporation.
2. 12 C.F.R. § 221.3(a)(1).
3. 12 C.F.R. § 221.2
4. 12 C.F.R. § 221.2. Publicly offered debt securities are not subject to the margin regulations if the public offering is bona fide. See, e.g., Staff FRB Op. FRRS 5-927 (Oct. 18, 1978) and Staff FRB Interpretive Letter, 1974 WL 26651 (Mar. 26, 1974); see also Board Release, 51 Fed. Reg. 1771-01, 1775 (Jan. 10, 1986). While there is an interpretative question as to whether an offering of registered notes is a bona fide public offering, this is not relevant to the negotiation of financing commitments. Indeed, even in transactions where the financing structure contemplates an issuance of registered notes, financing commitments typically contemplate financing in the form of bridge loans which are not publicly offered debt securities.

an amount that exceeds the maximum loan value of the target stock (which is set by the FRB at 50% of the current market value of such stock[5]) may not be secured directly or indirectly by the target stock.

It is not necessarily sufficient that the bidder does not pledge stock of the target to secure a purpose credit in excess of the maximum loan value of such stock, whether because the bidder is an investment grade company that typically obtains financing on an unsecured basis, or because the stock of the target is excluded from the collateral package. Unless an explicit exception is applicable, the financing arrangements will run afoul of Regulation U, if they are "indirectly secured" by the stock of the target.

Regulation U explicitly excludes certain arrangements that are not directly secured by margin stock from the "indirect security" doctrine, including arrangements that satisfy one of the following conditions: (x) after applying the proceeds, not more than 25% of the value (determined by any reasonable method) of the assets subject to the arrangement is represented by margin stock; (y) the lending arrangements permit acceleration of the maturity of the credit as a result of a default or re-negotiation of another credit to the customer of another lender that is not an affiliate of the (margin-lending) lender or (z) the lender, in good faith, has not relied on the margin stock as collateral in extending or maintaining the credit.[6] An analysis of these exceptions is beyond the scope of this article, but, unless one of these exceptions is clearly applicable -- which is often not the case -- the parties will need to structure the financing arrangements in a manner that does not constitute an indirect security interest in the stock of the target.

Under Regulation U, credit arrangements deemed to be indirectly secured by margin stock include arrangements under which either (i) the customer's right or ability to sell, pledge, or otherwise dispose of margin stock owned by the customer is in any way restricted while the credit remains outstanding, or (ii) exercising such right could be a cause for accelerating the debt.[7] This is not an exclusive list of indirect security arrangements; indeed, a staff opinion from the FRB notes that indirect security exists if a lender "by any arrangement or device, has an opportunity to reach the stock to ensure repayment" and relies on the margin stock covered by the arrangement.[8] Because indirect security arrangements may result from covenants of general applicability,[9] to avoid a finding that indirect security exists, certain negative covenants in the financing documentation may require explicit carve outs so as not to restrict margin stock.

Example of covenants that could create indirect security include:

(i) A negative pledge covenant. The Code of Federal Regulations explicitly states that a bank providing credit is indirectly secured by margin stock when a borrower promises a bank lender not to encumber margin stock (among other assets) owned by the borrower.[10]

(ii) A mandatory prepayment requirement triggered by the sale of the target stock. Note, however, that asset sale restrictions as such are not necessarily problematic. For instance, indirect security was found not to exist where a borrower could sell the margin stock for cash, without advance notice to the lender, so long as fair value was received and proceeds were held as cash or reinvested in cash equivalents.[11]

In addition, cross-default provisions in financing arrangements for the acquisition of the stock of a target raise a potential Regulation U compliance issue to the extent triggered by breach of covenants that (x) are set forth in other agreements of the target that are not themselves "purpose credits" and (y) could be viewed as creating an indirect security arrangement if included in the financing for the acquisition of the target stock. Indeed, the lenders extending the purpose credit could be viewed as indirectly receiving the benefit of these covenants through their reliance on the cross-default provision. This is especially the case if the "purpose credit" and the other agreements that include the potential problematic provisions are entered into with the same lenders or affiliates of those lenders.[12]

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5. 12 C.F.R. § 221.7.
6. 12 C.F.R. § 221.2
7. 12 C.F.R. § 221.2
8. Staff FRB Op. FRRS 5-901 (Feb. 25, 1970).
9. A 1984 FRB opinion found that, where a negative covenant applied to all of a borrower's assets, unless the borrower availed itself of the 25% exception even a de minimis holding of margin stock would render Regulation U applicable. Staff FRB Op. FRRS 5-917.17 (June 15, 1984).
10. 12 C.F.R. § 221.113(f)(2). See also a 1973 FRB opinion, which found that a negative covenant prohibiting a borrower from encumbering its property, which included substantial amounts of stock, would indirectly secure margin stock unless the margin stock was specifically carved out from the negative covenant and the lender did not rely on the margin stock as security. Staff FRB Op. FRRS 5-906 (May 25, 1973).
11. Staff FRB Op. FRRS 5-917.131 (Mar. 19, 1982), Staff FRB Op. FRRS 5-917.151 (Aug. 26, 1983).
12. Alaska Interstate Co. v. McMillian, 402 F. Supp. 532, 561-62 (D. Del. 1975).

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The practice in financing commitments for hostile tender offers varies, but outlined below are a few common provisions that can be helpful in complying with the indirect security doctrine.

- Commitments often specify that the restrictions on liens (as well as sometimes other covenants and agreements) set forth in the financing documentation shall not apply to the stock of the target.
- Commitments often contemplate that proceeds from the sale of the shares of the target are not required to be applied to pay down the loans under an asset sale prepayment requirement.[13]
- The cross default provision sometimes includes an exception for certain cross default and cross acceleration provisions in other agreements that would raise Regulation U compliance concerns.[14]

These exclusions are needed only until the closing of the back-end merger at which point the stock of the target will be delisted and no longer constitute margin stock. The applicability of the various exceptions prior to the closing of the back-end merger is typically negotiated. One approach is to provide that the relevant exceptions are applicable to the extent required by the margin regulations (which postpones the discussion of the applicable requirements to the negotiation of the definitive documentation). Another approach is to limit the exclusions to the extent the value of the stock of the target exceeds 25% of the total value of all assets subject to the relevant covenants and agreements.[15] As a practical matter, this approach is difficult to monitor because of the complexity involved in applying the 25% valuation exception, which requires an identification of the assets "subject to the arrangement" in order to determine the denominator of the ratio. However, it is supported by a FRB interpretation that held that where a negative pledge covering margin stock excluded all margin stock in excess of 25% of the value of the borrower's assets, no indirect security existed.[16]

* * * *

While a dual track financing commitment may seem like a complicated arrangement to negotiate, the good news is that a number of precedents now exist. These signposts point the way to a market approach to deal with the issues discussed in this article, and should facilitate the negotiation of future dual track financing commitments. That basis for consensus will come handy should the market for hostile debt-financed tender offers be active in 2012.[17]

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13. See ACI Commitment, supra note 1, which excludes from the asset sale prepayment requirement any disposition of shares of the target prior to the closing date of the back-end merger. See also Commitment Letter from UBS Loan Fin. LLC and UBS Sec. LLC to Int'l Paper Co. (July 7, 2011), available at http://edgar.sec.gov/Archives/edgar/data/51434/000119312511186393/dex99b1.htm.

14. See ACI Commitment, supra note 1, which contemplates that the event of default triggered by defaults under other agreements or instruments of indebtedness will include an exception for cross default and cross acceleration provisions to other indebtedness that would otherwise subject the loans under the facilities to requirements of Regulation U. See also the Air Products credit agreement dated March 31, 2010 with JPMorgan Chase Bank, N.A. (the "Air Products Credit Agreement") attached as Exhibit 10.7 to Air Products' Form 10-Q for the quarter ended March 31, 2010, which contemplates that the cross acceleration event of default shall not apply to indebtedness that becomes due as a result of an event of default under any agreement with a lender or an affiliate of a lender to the extent such default results from a sale, pledge or other disposition of margin stock with a value in excess of the 25% exception.

15. See Commitment Letter from J.P. Morgan Sec. Inc. and J.P. Morgan Chase Bank, N.A. to Air Prods. and Chems., Inc. (Mar. 3, 2011), available at http://edgar.sec.gov/Archives/edgar/data/2969/000095015710000366/ex99-b2.htm, which contemplates that: "Notwithstanding anything set forth herein to the contrary, for so long as any securities of Flashback constitute "margin stock" within the meaning of Regulation U, the restrictions on liens and other covenants or agreements set forth in the Credit Facility Documentation shall not apply to such securities to the extent the value of such securities exceeds 25% of the total value of all assets subject to such covenants and agreements." See also ACI Commitment, supra note 1, which contemplates that: "for so long as the securities of the Target constitute "margin stock" within the meaning of Regulation U, the negative pledges and restrictions on liens set forth in the Loan Documents shall not apply to such Shares to the extent the value of such Shares, together with the value of all other margin stock held by the Borrower and its subsidiaries, exceeds 25% of the total value of all assets subject to such covenants

16. Staff FRB Op. FRRS 5-915 (Apr. 2, 1979).

17. The author would also like to thank Oran Ebel and Alexandru Mocanu for their contributions to this article.

Purchase Price Adjustments: GAAP versus Consistency and Recent Cases

By Brian J. Massengill, Dana S. Douglas, and Paul M. Crimmins

Introduction

It has become standard practice for purchase agreements to contain purchase price adjustment provisions.[1] These provisions are typically designed to adjust a purchase price up or down by reference to certain designated components of a balance sheet or income statement.

Additionally, acquisition agreements contain indemnification provisions granting (and limiting) the buyer's indemnification rights. These provisions aim to provide a seller with some assurance as to the minimum net proceeds of a transaction. The purchase price adjustment provisions can become intertwined with the indemnification provisions, in that often both will apply to a common disputed issue. Careful drafting of these provisions is important to obtain the best result for your client in the event of a purchase price adjustment dispute.

According to studies performed by a subcommittee of the American Bar Association, 82% of acquisition agreements contained a post closing purchase price adjustment provision in 2010 as compared with 79% in 2008 (and 38 percent of acquisition agreements contained an earn out provision in 2010 as compared with 29 percent in 2008).[2] Because of the prevalence and importance of such provisions, as well as the complex mix of legal and accounting issues inherent in the creation and enforcement of the purchase price adjustment provisions, both lawyers and accountants should be involved in the agreement process as early as possible.

This article discusses some of the important strategic considerations in drafting purchase price adjustment provisions to help parties achieve their desired results.

Specify Precisely How the Adjustment Will Be Measured – The Issue of GAAP versus Consistency

Many post-closing misunderstandings arise simply because the parties to the agreement have different views about the purpose of the purchase price adjustment and the application of GAAP versus consistent application of past accounting practices. These differences can be resolved, and disputes avoided, through careful drafting.

For example, one party to the agreement (typically the seller) often assumes that the basic purpose of the purchase price adjustment is to compensate the buyer or seller for changes in

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1. Generally, there are two types of purchase price adjustments mechanisms. The first type provides for adjustments based on the difference between a target amount of a balance sheet metric (e.g., working capital, net assets, variations of working capital or net assets, or other measures) and the amount calculated under the same measure at the closing date (i.e., closing balance sheet adjustments). The second type provides for additional consideration to be paid to a seller if an acquired business meets certain contractually defined benchmarks (i.e., earn out adjustments).
2. Information from the 2011 Private Target Mergers & Acquisitions Deal Point Study of publicly available acquisition agreements for transactions completed in 2010 that involved private targets being acquired by public companies, and the 2009 Private Target Mergers & Acquisitions Deal Points Study of publicly available acquisition agreements for transactions completed in 2008 that involved private targets being acquired by public companies. The Private Target Mergers & Acquisitions Deal Points Studies were projects of the Mergers & Acquisitions Market Trends Subcommittee of the Mergers & Acquisitions Committee of the American Bar Association's Business Law Section.

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net assets[3] resulting from the operation of the business during the time between the date of the reference balance sheet that was used in setting the purchase price and the closing date. The other party (typically the buyer) frequently views the adjustment provision as a means of making certain that net assets delivered at the time of closing satisfy the reference "peg" amount shown in the reference balance sheet, or that the final purchase price will be revised upward or downward to the extent that a minimum dollar amount of net assets delivered differ.

Parties to the agreement often believe that their approach is reflected in purchase price adjustment provisions that calls for the closing balance sheet (used to measure the differential from the reference balance sheet) to be prepared in accordance with generally accepted accounting principles ("GAAP") applied on a consistent basis. However, GAAP and consistency requirements may conflict.

The reference balance sheet itself may contain errors or the methods used to estimate reserves in the reference balance sheet may no longer be reasonable (i.e., compliant with GAAP) as a result of changes in the business or economy. When such disputes arise, a party holding the view that the purchase price adjustment was intended to simply measure the change during the period between the reference balance sheet and the closing date generally argues that consistency must prevail over GAAP. Alternatively, a party holding the view that the adjustment is intended to ensure the delivery of a specified amount of net assets will generally argue that GAAP should prevail over consistency.

The parties also may disagree about the application of the acquired business's past accounting practices. GAAP often does not require the use of specific methods with regard to certain judgments and estimates in the financial statements. For example, the buyer may believe that the target business is not adequately reserved against doubtful receivables and may adjust the closing balance sheet and purchase price downward to reflect this position. But the seller may apply the same methods it has historically used and respond that past accounting practices do not require the additional reserve. Therefore, specifying the intended accounting method or basis of estimation, including accounting for latitudes allowed within GAAP, can require intricate drafting and careful diligence into the accounting methods underlying the prior financial statements of the acquired business, and a separate schedule of detailed "accounting principles" annexed to the agreement.

Another important consideration is the correct purchase price adjustment metric. Purchase agreements are using increasingly complex purchase price adjustment mechanisms. Buyers and sellers often include provisions calling for adjustment of the final purchase price on the basis of changes in balance sheet items such as: net assets; net working capital; net assets or net working capital excluding certain identified assets and liabilities or with certain amounts (such as reserves) established at a pre-specified amount; or net assets or net working capital determined on a contractually-modified version of GAAP. Other purchase price adjustment mechanisms may be designed to allow the seller to share in future earnings, for example, by adjusting the price to include a multiple of operating earnings, EBITDA or cash flow for a specified period after closing.

Determining how much of the balance sheet will be subject to measurement is a key consideration in selecting the purchase price adjustment mechanism. The parties need to consider the practical impact of using a "net assets" metric versus a "working capital" metric. If the agreement provides for a purchase price adjustment simply measured by the change in net assets, then the entire balance sheet (*all* assets and liabilities) is open to potential dispute. Alternatively, an adjustment measured by the change in working capital limits the potential disputes to only current assets and current liabilities.

If the purchase price adjustment mechanism selected encompasses judgmental accounting items, consider specifying how such items are to be measured. For example, reserves that are based on subjective judgments or factors can be made less vulnerable to dispute by inserting a provision in the agreement that permits no changes to the reserves included in the benchmark balance sheet, or that only permit changes based on clearly specified factors. When parties agree to such GAAP modifications, the modifications should be explicitly set forth in the purchase agreement (e.g., itemizing in a schedule to the agreement) in order to avoid any ambiguity as to their appropriateness or applicability. Sellers, in particular, should carefully consider where judgmental accounting items reside on the bal-

3. Or working capital, or the other pertinent financial metric.

ance sheet (e.g., allowance for doubtful accounts in current assets; goodwill and potential impairment of long-lived assets in long-term assets) when deciding on a purchase price adjustment mechanism.

Additionally, parties should consider expressly stating whether GAAP or consistency will prevail as the higher and controlling standard where GAAP and consistency requirements appear to conflict, and whether errors on the reference balance sheet shall be respected (not subject to challenge or adjustment) for purposes of calculating the purchase price adjustment.

The (Unexpected) Impact of Governing Law

A carefully drafted dispute mechanism clause can be the difference between an efficient arbitration and a drawn out court process. It generally is preferable that disputes related to the purchase price be resolved by an independent accountant rather than a court. Using an accountant to resolve purchase price disputes ensures that the process will be conducted by an arbitrator with expertise and experience in applying and interpreting accounting provisions and procedures. In addition, a private accounting arbitration should prevent the public disclosure of confidential or sensitive documents or information that occurs in a court proceeding. A thorough provision will clearly set forth exactly which questions will be decided by the neutral accountant and will resolve the issue of how to proceed in the event that a dispute could be characterized as *both* a closing balance sheet adjustment and a breach of a representation or warranty resulting in an indemnification claim. Precise drafting to address this area is crucial.

Recent cases highlight the importance of clearly drafted provisions. In the Delaware case of *OSI Systems, Inc. v. Instrumentarium Corp.*,[4] the purchase agreement contained a purchase price adjustment provision that required submission of working capital disputes to an independent accountant. But the agreement also contained a seller's representation that the initial working capital statement had been prepared in accordance with GAAP. The buyer later disputed that the seller's accounting complied with GAAP and claimed that, under GAAP principles, the working capital on the date of closing was $30 million less than the amount in the initial statement. The court held that this disagreement involved an indemnification claim rather than a purchase price adjustment dispute and that the claim had to be resolved by a legal arbitrator,[5] not the independent accountant. Thus, the dispute was subject to the caps and baskets set forth in the agreement's indemnification provisions.

In *Matria Healthcare, Inc. v. Coral SR LLC*,[6] the Delaware court reached a different result because of the specific language in the agreement that contained a post closing adjustment provision requiring that working capital disputes be submitted to an independent accountant. The agreement also required legal arbitration of disputes "relating to any Claim" between the parties. Recognizing that some disputes could qualify as both a post closing adjustment claim and an indemnity claim, the agreement provided that the accountant would be the default arbitrator for purchase price adjustment disputes. The buyer later claimed the seller had misrepresented the initial reference working capital amount by neglecting to inform the buyer of a customer complaint. Because the parties had selected the accountant as the default arbitrator for disputes over purchase price adjustments, the court ordered submission of the claim to the accountant.

In order to avoid court intervention to resolve procedural issues, the parties can designate the accountant to decide procedural questions as well as substantive accounting disagreements. In the Seventh Circuit Court of Appeals case of *Lumbermens Mut. Cas. Co. v. Broadspire Management Services, Inc.*,[7] the purchase agreement provided that the seller could dispute the buyer's periodic financial reports by submitting a reasonably detailed "Disagreement Notice." The agreement designated an accountant to resolve these disputes. After closing, the seller submitted disagreement notices, but the buyer claimed that the notices lacked the required detail. The buyer argued, therefore, that the seller had not met the preconditions for arbitration before the accountant and refused to arbitrate. The seller petitioned a federal court to compel arbitration, and the court held that the accountant should decide whether the notices were adequate. The court stated that such procedural questions about conditions precedent to arbitration were for the arbitrator to decide, especially where the arbitra-

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4. 892 A.2d 1086 (Del. Ch. 2006).
5. The agreement provided for legal arbitration of disputes relating to indemnification claims for breach of representations and warranties.
6. No. 2513-N, 2007 WL 763303 (Del. Ch. March 1, 2007).
7. 623 F.3d 476 (7th Cir. 2010).

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continued

tor was an accountant who would have more expertise than a court.[8]

As these cases demonstrate, courts in different jurisdictions might interpret the terms of a purchase price adjustment provision in different ways. A court applying Delaware law, as in *OSI Corp.*, may proceed to decide to resolve any accounting disputes over working capital. A court applying federal law in the Seventh Circuit, as in *Lumbermens*, may be more likely to defer to the accountant for accounting matters.

While courts in different jurisdictions may reach different outcomes regarding the appropriate forum for the resolution of disputes where the contract language is ambiguous, all courts that have considered the issue agree that unambiguous contract language controls.[9] As a result, it is important for the purchase price adjustment clause to clearly and unambiguously state which forum decides exactly which disputes.[10]

Specify the Process for Access to Records

The right of access to books and records, as well as the timing of such access, is an important consideration in drafting the adjustment provision. The purchase price adjustment provisions should specify when and under what circumstances a party is able to obtain access to the applicable financial books and records.

For the seller, which no longer has access to the records, this provision is particularly critical so that it has timely access to the appropriate records to object to any closing balance sheet adjustment. Without timely access to the records, a seller faced with closing balance sheet adjustments may be left with no choice but to object to each and every adjustment, thus adding unnecessary complication and cost to the purchase price adjustment process.

The purchase price adjustment provision also should specify how disputes about access requests will be resolved. Establishing the timeline for complying with an access request, the mechanism through which a party can object to access requests, and expressly providing that the accountant arbitrator will resolve any disputes, will reduce uncertainty and provide further efficiency to the process.

The Interplay of Post Closing Disputes and Breach of Representation and Warranty Claims

The purchase price adjustment provision should be considered in conjunction with the representations and warranties. The indemnification provisions in a purchase agreement typically require the parties to indemnify each other against breaches of the agreement's warranties, representations, and covenants. Issues arise when one party claims that the purchase price should be subject to adjustments based on an accounting issue that could be also characterized as a breach of a financial statement representation resulting in an indemnification claim. Whether a dispute is properly classified as a purchase price adjustment dispute or an indemnification claim is not a mere semantic exercise.

The timing of when to raise a dispute depends on whether it is a purchase price adjustment or an indemnification claim. Disputes regarding the preparation of the post-closing balance sheet typically must be asserted within the time frame dictated by the terms of the purchase agreement, such as 30 days after receipt of the post-closing balance sheet. Claims for indemnification typically can be brought for a much longer period after the deal closes.

The purchase agreement will likely contain limitations on indemnification rights, such as "baskets," that limit recovery until a specific dollar amount of claims are incurred. In turn, each "basket" of liability may be capped at a certain "ceiling," limiting the dollar amount of liability in play.[11] Thus, even meritorious claims under the

8. Similarly, the Second Circuit recently reiterated its position that ambiguities in a purchase agreement arbitration provision should be resolved in favor of arbitration. Bechtel do Brasil Construcoes Ltda. v. UEG Araucaria Ltda., 638 F.3d 150 (2d Cir. 2011). In Bechtel, the purchaser had bought a power plant, but a turbine at the plant failed eight years after the purchaser accepted delivery. The purchaser submitted a demand for arbitration with the International Chamber of Commerce ("ICC"), and the seller moved a New York court to stay the arbitration as time-barred. The federal district court found that the timeliness issue should be settled by a court because the parties had agreed that the contract would be interpreted under New York law. On appeal, the Second Circuit reversed, holding that whether the claim was time-barred was presumptively a question for the arbitrator to decide in the first instance.

9. In interpreting the relevant clauses, courts will typically look to the plain language of the contract. If there are ambiguities in the terms of the agreement, however, courts will look to the parties' intent.

10. This does not mean that a dispute cannot be characterized as both a purchase price adjustment and a breach of representation and warranty resulting in a claim for indemnification. The same dispute may be appropriately characterized as both depending when the dispute arises and the method used to calculate the adjustment.

11. These contractual limitations on a party's indemnification rights typically will not be effective against claims of fraud or intentional misrepresentation.

indemnification provisions may provide limited or no recovery. The buyer is also unlikely to want to expend its limited indemnification protections on issues that could be classified as purchase price adjustment disputes.

Further, purchase price adjustment disputes are generally resolved by an independent accountant arbitrator while indemnification disputes are typically court proceedings. A well-prepared purchase price adjustment provision will clearly state the scope of disputes to be decided by the accountant arbitrator and will resolve the issue of how to proceed in the event that a dispute may appropriately be characterized as *both* a closing balance sheet adjustment *and* an indemnification claim. Significant legal fees can be saved if the appropriate forum for resolution of such disputes is unambiguous. Otherwise, the parties may have to proceed to court to determine the appropriate forum for the dispute before reaching the merits of the claim. Therefore, the purchase agreement should clearly specify both the substantive method for adjusting the purchase price and the desired procedure for resolving adjustment disputes.

Conclusion

Purchase price adjustment clauses are an increasingly important and prevalent feature in purchase agreements. Disputes over purchase price adjustments can be complex, especially because such disputes may overlap with issues that are governed by the contractual indemnification clauses. When drafting purchase price adjustment provisions, parties should be clear and unambiguous in describing the substantive methodology for adjusting the purchase price. Parties must also consider the procedural clauses governing the resolution of any future purchase price adjustment dispute. For example, the parties should specify the kinds of disputes that will be decided by an accountant rather than a court. Finally, because purchase price adjustment disputes involve a complex mix of legal and accounting issues, lawyers and accountants should be involved early in order to ensure that the appropriate provisions are in place and are being enforced throughout the process.

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