GIBSON DUNN
M&A REPORT

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TACKLING CARVE-OUTS: IMPORTANT ISSUES IN SALES OF DIVISIONS AND SUBSIDIARIES

Sales of divisions or subsidiaries, so-called “carve-outs,” are among the most complex M&A transactions. Carve-outs often necessitate not only a complicated division of assets and liabilities between the parent and the carved-out business, but also a comprehensive understanding of the carved-out business and how it will operate once it is separated from its parent. Nonetheless, these transactions have been steadily increasing over the last five years, possibly as an avenue for sellers to unlock growth and stockholder value and as a way for buyers to effectively use the extraordinarily low interest rates and the historic levels of cash that many corporations have built up on their balance sheets.

In the past five years, in the U.S., the number of carve-out M&A transactions per year has been increasing relative to the number of non-carve-out transactions, with carve-out transactions exceeding 50% in number of U.S. deals in 2012 (as shown in Figures 1 and 2 below). In addition, the aggregated value of carve-out transactions per year has shown steadier growth than non-carve-out M&A transactions (as shown in Figure 3 below).

Figure 1

Number of U.S. Deals Over $100 Million

	Carve-outs		Non Carve-outs		
Year	Number	Percent	Number	Percent	Total
2008	247	45.8%	292	54.2%	539
2009	170	45.6%	203	54.4%	373
2010	328	46.3%	380	53.7%	708
2011	368	46.6%	421	53.4%	789
2012	426	51.6%	400	48.4%	826

Source: Thompson Financial

WHAT’S INSIDE

TACKLING CARVE-OUTS: IMPORTANT ISSUES IN SALES OF DIVISIONS AND SUBSIDIARIES
Page 1

RENEWED FOCUS ON “UNBUNDLING”
Page 2

ASSUMPTION OF LIABILITIES IN CARVE-OUT TRANSACTIONS
Page 3

STAND-ALONE FINANCIAL STATEMENTS IN CARVE-OUT TRANSACTIONS
Page 7

GOLDEN PARACHUTE COMPENSATION PRACTICE POINTERS
Page 9

UK M&A AND CORPORATE CASE LAW UPDATES
Page 13

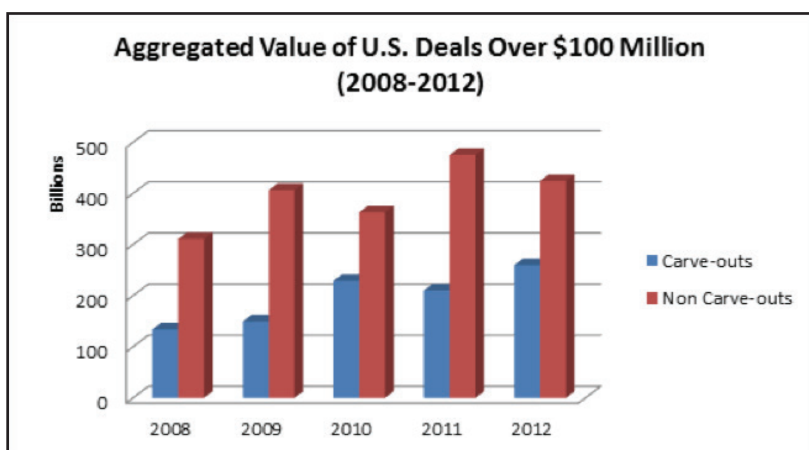
DELAWARE STREAMLINES PUBLIC COMPANY ACQUISITION TIMELINES
Page 20

M&A AT GIBSON DUNN
Page 22

Figure 2

Source: Thompson Financial

Figure 3



Source: Thompson Financial

Included in this edition of the M&A Report are two articles that address important issues in carve-outs. The first article discusses issues in connection with the transfer of liabilities in a carve-out transaction, and the second describes the importance of stand-alone financial statements for the business to be carved out. These articles begin on the next page.

RENEWED FOCUS ON "UNBUNDLING"

The recent decision by the U.S. District Court for the Southern District of New York in *Greenlight Capital LP v. Apple Inc.*[1] serves as a good reminder of the importance of ensuring that management proposals do not run afoul of the Securities and Exchange Commission's ("SEC") unbundling rules. Impermissible "bundling" of management proposals, as covered by Rule 14a-4(a)(3) and 14a-4(b)(1) promulgated under the Securities Exchange Act of 1934, as amended, is the practice of combining two or more separate matters as one proposal, such that shareholders must evaluate and vote on issues as a single matter, rather than voting on each matter individually. The *Greenlight* decision focused on the disclosure in Apple's proxy statement, which included a proposed amendment to Apple's articles of incorporation that, if approved, would: (1) facilitate majority voting for incumbent members of Apple's directors; (2) revoke the board of director's power to unilaterally issue preferred stock; (3) establish a par value for Apple's common stock; and (4) eliminate certain obsolete provisions, such as references to preferred stock.

Plaintiff, Greenlight Capital, alleged that Apple's proposal violated the SEC proxy rules prohibiting the "bundling" of multiple items. Judge Richard J. Sullivan rejected Apple's argument that the proposal was merely a single proposal to amend its articles of incorporation, and ordered the matters unbundled. Importantly, the court noted that Apple could not simply rely upon the prevailing market practice (coupled with apparent SEC inaction) with respect to bundling management proposals—the court was compelled to exercise its "independent judgment" regarding the matter.

1 *See Greenlight Capital LP v Apple, Inc.*, Case 1:13-cv-00900-RJS, ECF No. 28 (S.D.N.Y. Feb. 22, 2013).

ASSUMPTION OF LIABILITIES IN CARVE-OUT TRANSACTIONS

One of the most difficult, and therefore most heavily negotiated, issues in carve-out transactions is the division of liabilities between the parent and the carved-out business. Typically, the division of liabilities will follow the business: liabilities attributable to the parent's business will be retained by the parent, and liabilities attributable to the subsidiary or division's business will be assigned to the subsidiary or division. As explained below, in the case of an M&A transaction, this application can vary depending on whether the transaction is a stock sale or an asset sale.[1]

- **Stock Sale.** In a stock sale, liabilities of the carved-out entity typically pass to the buyer by operation of law. The carved-out entity is acquired "as is" with all of its existing liabilities. However, to the extent the parent is creditworthy, the buyer may be able to obtain protection from certain liabilities through indemnification.

- **Asset Sale.** In an asset sale, by contrast, the buyer is contractually responsible only for those liabilities that it specifically assumes as part of the negotiated asset purchase agreement. This flexibility allows the parties to choose from any number of liability arrangements, from "all liabilities resulting from the ownership and operation of the carved-out division" to only specifically enumerated liabilities in a schedule, with the parent typically providing unlimited indemnification for all other liabilities. However, even where the buyer does not expressly agree to assume any liabilities, the buyer should be aware that it may nonetheless be subject to certain successor liabilities arising out of the asset purchase.[2]

- **Applicable Law.** No matter what the transaction structure, both parties should be aware that under applicable state, federal or international law, certain environmental, product and employee liabilities may pass to the buyer or be retained by the parent even if the parties have contractually provided for another allocation.

In most cases, both parties would be expected to attempt to avoid assuming or continuing to be liable for as many liabilities as possible. However, there may be significant business reasons why a party may want to retain or assume certain liabilities. For example, the buyer may want to assume certain contingent

1 In addition, we note that even for carve-outs structured as initial public offerings or tax-free spin-offs, the same issues must be addressed in the separation or distribution agreement.

2 *See, e.g.*, *Teed v. Thomas & Betts Power Solutions, L.L.C.*, 713 F.3d 763 (7th Cir. 2013) (extending successor liability for an asset acquiror to suits brought under the Federal Labor Standards Act despite an express disclaimer in the sale contract).

Given the court's emphasis on independent judgment over prevailing market practices, the *Greenlight* decision is likely to embolden plaintiffs' counsel to challenge management proposals. This potential trend is evidenced in another recent lawsuit against Groupon.[2] The putative class action suit filed by Groupon's shareholders involves a challenge to Groupon's bundling of proposals within the context of amendments to the company's equity compensation incentive plan. Specifically, plaintiffs claimed that Groupon impermissibly bundled, into one proposal: (1) an increase in the total number of shares allowed under the plan; (2) an increase of the share limit for each individual recipient under the plan; and (3) ratification of an existing award already made to the company's COO (in excess of the plan's then current limit).[3]

Unbundling issues can also arise in the M&A context. Indeed, the primary SEC guidance available on unbundling was directed at proposals in the merger context.[4] Bearing in mind that prevailing market practices may no longer be sufficient to defend against a charge of bundling, below are several points to consider when preparing proposals in the M&A context:

1. The SEC seeks to prevent shareholders from being coerced into having to accept the bad with the good, and the SEC wants shareholders to be able to effectively communicate their preferences (via a yes, no, or abstention vote) on each "separate matter."

2. Substance over form: merely describing several distinct proposals as a "single" proposal to "amend

2 *See MacCormack et al v. Groupon Inc.*, Verified Class Action Compl., Case 1:13-cv-00940-GMS, ECF No. 4 (D. Del. May 24, 2013).

3 Groupon held its annual meeting on June 13, 2013, and the proposal was approved by a majority of shares voting; however, because the proposal is the subject of a pending lawsuit, Groupon did not certify the results of the proposal pending the outcome of the lawsuit.

4 Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fifth Supplement, September 2004. Available at: http://www.sec.gov/interps/telephone/phonesupplement5.htm.

liabilities, such as warranty obligations for products sold pre-closing to ensure the business runs smoothly and continues to retain a loyal customer base. Similarly, the parent may wish to retain control of certain disputes if adverse publicity or an adverse resolution of the dispute has the potential to create broader problems for its retained businesses.

Liability allocation can also present a potentially profitable arbitrage opportunity for a party if such party expects the ultimate exposure to be less than the amount that the other party is anticipating. For example, if the buyer estimates it will have to spend $5 million to settle an ongoing litigation claim related to the carved-out business while the parent believes it can negotiate a $2 million settlement, the parent may agree to retain the liability in exchange for an increase in the purchase price in excess of $2 million.

Often, the buyer and the parent will also agree to indemnify the other for any damages or losses that relate to the liabilities assumed or retained by them. These indemnification arrangements are often subject to time limits or caps. Parties also have the option of obtaining representation and warranty insurance to address certain of these risk allocation issues.

Specific Liabilities

(a) Balance Sheet Liabilities

Liabilities on the face of the balance sheet of the entities, because they are known and quantifiable, may be the easiest to address. Whether a stock sale or an asset sale, these financial liabilities, such as payables, can typically be accounted for in the purchase price or purchase price adjustment mechanism.

(b) Environmental Liabilities

Environmental liabilities generally follow the business that generated them. Sometimes, however, the parent may have developed a comparative advantage in handling such liabilities and will agree to retain them or agree to defend such claims in return for reimbursement of any related costs. The parties should also be aware that federal and state laws sometimes impose liability on the parent even if the carved-out business expressly assumes the liability. For example, the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) prevents a parent that has owned or operated a hazardous waste facility from transferring liability under the Act to any other entity or person, including the carved-out business.[3] In such cases, the buyer may seek protection through indemnification to the extent that the parent is creditworthy.

3 42 U.S.C § 9607(e) (2012).

the Articles" will not prevent a subsequent challenge in court or through SEC comment.

3. As a general matter, corporate governance and control-related provisions should be unbundled (*e.g.* classified or staggered boards, limitations on the removal of directors, supermajority voting provisions, an attempt to delay an annual meeting for more than a year, an attempt to eliminate the ability to act by written consent, etc.).
4. The completion of a merger can still be conditioned on the passage of a shareholder proposal that is separate from the merger (but such a condition should be disclosed prominently in the proxy statement and on the proxy card).
5. The unbundling rule does not cover proposed changes to bylaw provisions that may otherwise be amended without a shareholder vote. Similarly, shareholder rights plans adopted in connection with a merger generally need not be unbundled because shareholder approval is typically not required.
6. When a target company is merging into a public acquiror (and the acquiror's shareholders are voting on the transaction because 20% or more of the acquiror's stock will be issued in the transaction), there should be no need for unbundling, assuming that the acquiror's charter and bylaws are not changing in any material respect.
7. If, in connection with a merger, the public acquiror's charter or bylaws will be amended to add or modify a material governance or control-related provision, then such changes will likely need to be approved separately by the acquiror's shareholders. Similarly, in a "stock-for-stock" merger where the target company's charter or bylaws include a material governance or control-

(c) Products Liability

Typically, under state law, products liability follows the business that manufactured or sold the product. However, both the buyer and the seller may have reasons for wanting to assume or retain this particular liability in exchange for a purchase price adjustment. As mentioned above, the buyer may seek to assume such liabilities to protect the customer relationships of the carved-out business. The parent, on the other hand, may be willing to assume these liabilities if it already has insurance to cover them (especially insurance for discontinued products). Regardless, the parties should consider whether the parties' allocation of liability will be effective to protect against third parties' product liability claims. If not, the parties will have to rely on an indemnification arrangement for such claims.

(d) Litigation

Litigation liabilities often present difficult issues because their contingent outcomes may materially affect the valuation of the spun-out business by whichever party assumes the liability. Parties can address litigation liabilities in a number of manners:

The parties may allocate the liability to the business that gave rise to the litigation;

The parties may agree to share joint and several or proportionate liability with respect to liabilities of the spun-out business, which will also include deciding which party will manage the litigation and what rights the other party will have with respect to approving a settlement;

The parties may single out specified liabilities of the spun-out business and establish special indemnification arrangements for specific matters;

The parent may agree to retain the litigation liability, control the litigation and indemnify the buyer; or

The parties may agree to certain purchase price adjustments depending on the final resolution of specified litigation matters.

(e) Employee, Employee Benefits and Related Liabilities

The parties need to consider allocation of employee-related liabilities, if any, that arise under state and federal law and any contractual obligations (*e.g.*, the parent's severance policies, employee benefit plans, employee agreements, collective-bargaining agreements, etc.). As part of its due diligence, the buyer should determine whether it expects to lay off employees. If so, the buyer should analyze whether the proposed reductions will create issues under the federal Worker Adjustment and Retraining Notification Act (WARN Act)[4] and analogous state laws. Additionally, the parties should consider who will bear the severance costs for terminated employees. In addition, where the transferred business is subject to employment contracts with change of control provisions, severance costs can

4 29 U.S.C. §§ 2101 to 2109.

related provision that will either be eliminated or modified in some material respect, target shareholders will likely need to vote on any such change(s) separate and apart from the merger proposal itself.

8. Unbundling is not required when shareholders of the target company are only entitled to cash consideration.
9. Matters that are "logically and inextricably" related to one another—such that approval of one would be meaningless without approval of the other—have been permitted by the SEC to be presented together (for example, increasing the authorized shares of a company's common stock in conjunction with reclassifying shares of the company's Class A common stock).[5] "Ministerial" or "technical" matters not affecting substantive rights may be bundled as well.
10. If a company is required to unbundle proposals, it may cross-condition them, effectively requiring that two or more proposals be approved in order for any to take effect. This functionally accomplishes the same objective of having a single proposal while still complying with the unbundling requirements.
11. SEC inaction to the apparent prevailing market practice of bundling certain shareholder proposals together was not given much weight in *Greenlight*. The court pointed to a lack of adequate SEC enforcement resources, rather than tacit acceptance of bundling activities, as the most plausible explanation of the SEC's inaction.

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5 One example of this is the response provided by Benihana Inc. to an SEC unbundling comment, available at: http://www.sec.gov/Archives/edgar/

sometimes be triggered even when an employee continues to be employed by the acquired business. It is also worth noting that with respect to employment liabilities, both parties often have reputational interests at stake. Some parent entities, seeking to protect their reputational interests, require the buyer to maintain an enhanced severance program for transferred employees for a period of time following the closing (usually one year). An often-adopted strategy is to give the buyer responsibility for liabilities related to the employees it seeks to hire while the seller retains the liabilities for the employees that will not be transferred with the carved-out business.

If any international operations are involved in the transaction, the parties should also consider any relevant foreign labor and employment laws. For instance, many foreign jurisdictions impose statutory severance obligations or require consultation or notice. In the European Union, the parties cannot contractually exclude certain employees from the transfer of the carved-out business without the employees' consent.[5]

The parties should recognize, however, that although these agreements may be effective between the parties, they may not be enforceable against third parties, including employees or the government. This is especially the case where employees have been exposed to health risks during the course of their employment, in which case third parties may claim that the parent retains liability even if it has been expressly assumed by the buyer.

(f) Contractual Obligations in General

The parties should make sure to obtain any required third-party consents for any significant contracts to be transferred between the parent and the carved-out entity. It is also worth noting that unless the contract provides otherwise, third-party consents are required to release the assigning party from liability.

Another important consideration relates to contracts, guarantees, insurance and credit support that the parent has obtained or entered into for the benefit of the subsidiary or division to be carved-out. For example, the parent may have obtained insurance for the subsidiary or division, or entered into a lease of facilities used by the subsidiary or division. Where these arrangements are not transferrable – either because they are part of a broader corporate structure that the parent intends to retain or because it is not economical for the carved-out business to assume them – the parties will have to consider substitute arrangements. It may be necessary for the parties to enter into a transitional services agreement whereby the parent will provide certain post-closing services to the carved-out business on a temporary basis.

Unidentifiable Liabilities

Unidentifiable liabilities are those liabilities that typically arise after the transaction is complete, but are not clearly traceable to the parent or to the carved-out business. For example, liabilities may arise following a post-carve out change in law that creates liability for pre-carve out actions, or on-going activities, both pre- and post-closing, such as Foreign Corrupt Practices Act (FCPA) violations. Many purchase agreements fail to address such liabilities, either by neglecting them altogether, or by assuming that they will be addressed by the dispute resolution mechanisms delineated in the agreement.

Parties that do address unidentifiable liabilities typically do so pursuant to the following methods:

- One party – usually the party most able to bear the liability – agrees to take responsibility for all unidentifiable liabilities;
- The parties agree to share responsibility for all such liabilities on a joint and several or proportionate basis; or
- The parties agree to establish a committee consisting of representatives from both the parent and the carved-out subsidiary or division, which will determine the allocation of any unidentifiable liabilities that arise after the transaction is complete.

5 See, e.g., EU Transfer of Undertaking Directive 2001/23/EC.

The Importance of Specificity

No matter how the liabilities are carved up, the agreement should precisely define which liabilities are being assumed, which are being retained and the mechanisms for protection from such liabilities, if any. These issues are likely to be heavily negotiated, and care must be taken to ensure that the stock or asset purchase agreement clearly reflects the parties' understanding.

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STAND-ALONE FINANCIAL STATEMENTS IN CARVE-OUT TRANSACTIONS

One of the most critical concerns during the planning stage of a carve-out transaction is the preparation and timing of stand-alone financial statements for the business to be carved out. In contrast to a sale of a stand-alone company in the typical M&A transaction, in the case of a carve-out of a subsidiary or division, the business to be carved out usually does not have separate financial statements. In the rare case where the subsidiary or division does have stand-alone financial statements, those statements are usually unaudited and may be inadequate for purposes of the buyer's due diligence and financial reporting requirements. As a result, preparation of separate, and potentially audited, financial statements can be time consuming, and preparation should be commenced early in the process.

Benefits of Stand-alone Financials

Stand-alone financial statements for the carved-out business can potentially benefit the transaction in a number of ways:

- **Increased Sales Price** – Stand-alone financial statements provide potential buyers with greater confidence regarding the correct valuation of the business to be carved out. Because many buyers are willing to pay a premium for certainty, stand-alone financials can make the buyer more willing to pay a higher sales price.

- **Access to Debt Financing** – Audited stand-alone financials are often required by lenders in order to offer financing for the transaction.

- **Public Filings** – If the buyer is a public company, it may be required to file audited financial statements with the SEC if the acquisition is a material one – *i.e.*, if it exceeds 20% of the buyer's prior assets, common shares or income.[1]

- **Increase in Number of Potential Buyers** – The increased certainty, additional financing options and ability to satisfy SEC filing requirements resulting from audited financial statements, mean that the seller offering these is likely to have more potential buyers.

1 17 C.F.R. §§ 210.1-02, 210.3-05 (2012). Financial statements of the carved-out business acquired or to be acquired must be filed for certain periods of time to the extent such business meets 1 of 3 significance tests. Generally, if the carved-out business exceeds the 20%, 40% or 50% (or if securities are being registered to be offered to security holders of the carved-out business) significance level for any of the three criteria, audited financial statements must be filed, respectively, for the 1, 2 or 3 most recent fiscal years (financial statements for the earliest of 3 fiscal years may be omitted if the net revenues of the carved-out business are less than $50 million in its most recent fiscal year), the interim period and the corresponding interim period of the preceding year (subject to certain other exceptions). The criteria for these tests are as follows: (i) the buyer's investment in the carved-out business as compared to the buyer's total assets; (ii) the total assets of the carved-out business as compared to the buyer's total assets; and (iii) the pre-tax income of the carved-out business as compared to the buyer's pre-tax income.

Timing Considerations

The process of preparing stand-alone financials, particularly if they are audited, can result in potentially costly transaction delays. Not only are such statements often time consuming to prepare, but the financial review process can be particularly complex if the subsidiary or division shares assets and services with its parent. Moreover, amounts that were previously not considered material by the parent may be material to the carved-out business, requiring a closer review of accounts and balances.

Sellers can attempt to reduce delays if the financial statements are completed and accurate prior to commencing the sales process. Otherwise, for instance, identifying subsequent inaccuracies in the financial statements will raise red flags with prospective buyers. Sellers may be tempted to expedite the process by limiting the scope of the financial statements to just one fiscal year. However, potential buyers may need financial statements for up to three full fiscal years to satisfy lenders and, in the case of public companies, to meet SEC filing requirements. Given these considerations, sellers are well advised to initiate the process as far in advance of the transaction as possible.

Cost Considerations

Preparing stand-alone financial statements can be expensive, particularly if the statements are audited. The seller will typically bear the preparation expenses if the statements are prepared in advance of the transaction to attract buyers or maximize the purchase price. But if the statements are prepared after the transaction is under way, particularly if the statements are specifically requested by the buyer, the parties can agree on how the expenses will be allocated. The parties should consider not only the initial preparation expenses, but also any revision expenses that may be required by lenders or the SEC.

Who Should Prepare the Financials?

It is typical for the parent's employees or internal or external accountants to prepare stand-alone financial statements. The parent's employees or accountants are familiar with the business and how the assets, revenues and services are divided or shared. Accordingly, they are generally able to prepare the statements more quickly and accurately than other parties.

In addition, even though the parent will have to provide a representation in the purchase agreement that the stand-alone financial statements fairly present, in all material respects, the financial condition of the carved-out business, the buyer should proceed with caution when relying on them – particularly with respect to the treatment of assets and services that are shared by the parent and the subsidiary since the buyer's future business decisions may result in significant variations from historical financial statements. The buyer should consider whether the carved-out business will need to secure new and possibly less-favorably priced assets and services, such as office space, insurance, management, IT services, human resources and accounting. If so, parent-prepared financial statements may not reflect the buyer's actual cost of running the carved-out business.

Closing Conditions and Purchase Price Adjustments

If stand-alone financial statements cannot be completed prior to the signing of the acquisition agreement, the buyer may request delivery of such financial statements as a closing condition. The closing condition may require that the financials be satisfactory to the buyer, providing the buyer with an additional opportunity to conduct due diligence and potentially terminate the agreement. Sellers often resist such closing conditions as a possible risk to the closing of the transaction.

Alternatively, if audited financial statements cannot be produced prior to the closing, the buyer may insist that the seller-provided pre-closing financial statements be confirmed by a post-closing audit. Any discrepancy between the pre-closing and post-closing financials would then be accounted for with a purchase price adjustment.

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GOLDEN PARACHUTE COMPENSATION PRACTICE POINTERS

For a variety of practical and legal reasons, compensation to be paid in connection with the sale of a public company (which this article will refer to as "golden parachute compensation") is best addressed well before an M&A transaction is being contemplated. There are a multitude of issues that are raised when designing these sorts of compensation arrangements, which generally focus on protecting a company's executives if their employment is involuntarily terminated following a change in control, and below is a checklist to assist companies in approaching many of the important considerations.

1. Timing and Process:

Establish These Arrangements When They are Not Expected to be Needed Soon

Boards and compensation committees can establish the best possible record if golden parachute compensation is established at a time when a deal is not in the offing. They can act in a more deliberate manner over multiple meetings. They can ensure that they have time to direct the collection of and evaluate the peer group data. They can obtain the advice of independent experts, usually compensation consultants and attorneys. For Delaware corporations, they can avoid the "heightened scrutiny" that is generally applied when evaluating the prudence of decisions made in anticipation of a particular transaction. Demonstrating a prudent process will better protect the Board against potential liability for allegations that they breached their fiduciary duty by providing this type of compensation.

Allow for Periodic Re-Evaluation of Substantive Benefits

Circumstances change. Golden parachute compensation packages should be re-evaluated periodically in order to ensure that they are still serving their intended purpose beneficial to preserving the value of the company for stockholders, which is to protect key employees against the risk of involuntary job loss without overpaying or underpaying. Overpayment is a less efficient use of corporate assets and underpayment raises the risk that the retentive qualities of these packages will not work as intended. In effect, these sorts of arrangements act as a form of insurance for key employees, and the amount of coverage needed can change with the passage of time. A typical cycle for re-evaluation would be every 2-4 years.

2. Triggering Events:

No Single Triggers

In the public company context, payments are rarely made simply because a company has been acquired. So-called "single trigger" payments are not consistent with the purpose of golden parachute arrangements that support value to stockholders, which is to retain key employees through a possible sale without having them distracted by personal concerns or encouraging them to leave. Accordingly, they are viewed unfavorably by institutional shareholders and their advisory shareholder voting services (such as ISS and Glass Lewis).

Carefully Crafted Double Triggers

Golden parachute payments are generally paid only upon the occurrence of both of two distinct events: (1) the sale of the company and (2) an involuntary termination of employment. Therefore these payments are frequently referred to as "double trigger" payments. The second trigger is usually pulled upon the occurrence of one of two types of events: (1) termination without "cause" and (2) resignation for "good reason". Most attention is generally paid to the "good reason" trigger, since it is more subjective and its presence raises a greater concern regarding compliance with Section 409A of the Internal Revenue Code. ("Good reason" definitions that are concluded by the IRS to be overly broad in scope raise concerns regarding whether an employee might become taxable on a portion of the golden parachute payments prior to actual receipt, and be charged with supplemental income taxes on top of regular income taxes.) In order to minimize those compliance issues, many companies use either a "safe harbor" definition for "good reason" specified in the Treasury regulations under Section 409A or a close relative of that safe harbor definition. While there are many issues that arise in the drafting of the definition of "good reason", here are two examples.

(1) Distance from current job. Often an employee may become entitled to leave for good reason if his or her principal job location significantly changes. Many agreements just use a stock number of miles; 35 or 50 miles are popular numbers. But where a job is located can dramatically affect the appropriate number of miles. While movements of less than 50 miles may not be too disruptive in smaller headquarters cities, such as Kansas City or Pittsburgh, such a move can be extremely disruptive in a major metropolitan area. It may be feasible to commute from Kansas City to Lawrence, KS but getting from Greenwich, CT to Newark, NJ or from Vallejo, CA to Silicon Valley (San Jose) can be a nightmare. So a reasonable distance depends on where the employee lives and works.

(2) Retention of same job. If an employee retains the same job, is that a "good reason"? Most definitions allow for "good reason" if there is a material diminution in position. A line manager may be able to continue to perform his or her job in a basically unchanged fashion both before and after a sale. But what about a CEO, CFO or GC? They are no longer responsible for the direction of an independent entity, but are now performing their jobs for a controlled subsidiary. So no change in an employee's position doesn't necessarily mean that there has been no adverse impact. Depending on how the good reason definition is drafted, some executives (typically the CEO, CFO or GC) may have good reason upon the occurrence of the sale itself by virtue of the diminution of their duties because they are no longer employed by a publicly-traded company.

3. Definition and Scope of Change in Control:

Be careful when defining "Change in Control"

There is no such thing as a standard definition for "Change in Control". This definition should be tailored to the company and for the intended use.

For example, what percentage of a company's stock should an acquiror possess in order to be said to have obtained "control"? For small public companies, it may make sense to require majority ownership. But for larger public companies with widely-held stock and fragmented ownership, a lower percentage ownership can allow an acquiror to exercise effective control. Percentages in the 30-40% range can be entirely appropriate for larger companies.

Generally, "change in control" will have a number of prongs intended to identify the various ways in which control of the management of the corporation can change. They typically include (1) stock purchases (including through mergers, consolidations and similar mechanisms), (2) asset purchases, (3) material changes in board composition over a limited period of time (*e.g.,* in connection with a hostile tender offer), and (4) liquidations. Any good definition will include as much detail as is necessary to ensure that the definition fits its intended use.

Length of the Protection Period

A related issue deals with how closely related the change in control needs to be to an involuntary termination. A usual period of time following an acquisition is 1 to 2 years. We recommend that the post-acquisition protection period be no shorter than 13 months in order to provide an acquiror some flexibility in minimizing the potential adverse impact of golden parachute taxes (discussed in more detail below). While an involuntary termination within one year of a change in ownership is considered to be materially related to that change (and therefore all payments made on account of termination generally are taken into consideration in calculating the golden parachute tax liability), an involuntary termination more than one year afterwards generally is not. That means that payments made on account of a termination more than one year after an ownership change can enjoy reduced or perhaps even no inclusion in the calculation of potential golden parachute taxes. Some periods also include a short period of time prior to the acquisition or provide that the termination will trigger "double trigger" payments if directed by the acquiror, even if it occurs before the deal closes.

4. Elements of Golden Parachute Payments

Each company will need to determine the appropriate composition of golden parachute payments. Here is what we generally see, and what is less common or rarely seen.

Commonly Seen Elements

- Cash salary continuation (for specified period), often paid in a lump sum
- Estimated cash bonus replacement (for specified period)
- Stock award vesting acceleration (often 100%)
- Continued paid benefits (esp. medical) for specified period
- Pro rata bonus for year of termination
- Confirmation re: indemnification

Less Commonly Seen Elements

- Outplacement
- Retirement benefits accrual continuation
- Continuation of selected perquisites (e.g., tax and financial planning, car allowance, etc.)

5. Approach to the Golden Parachute Tax

Section 280G (and its companion, Section 4999) of the Internal Revenue Code provide for adverse tax treatment of payments made in connection with a change in ownership of a corporation that is deemed by the law to be excessive. In general, payments are considered excessive if they exceed three times the executive's "base amount", which is his or her average taxable compensation from the prior five years. Golden parachute arrangements need to deal with how to address this law. Since the employee may under certain circumstances be required to pay a supplemental excise tax, in years past many companies provided employees with a tax reimbursement (a "gross-up") to compensate them for this additional liability. Since gross-ups can get extremely expensive for companies (especially since the application of Section 280G results in these payments being non-deductible to the company), many institutional investors and their advisors have heavily criticized the use of tax gross-ups in this context. In response, golden parachute gross-ups are now rarely seen, and then almost always only in arrangements that the company cannot amend unilaterally.

The most favorable approach for companies is to reduce so-called "golden parachute" payments to a level at which the adverse tax consequences are not levied, known as a "cutback". However, employees are not generally supportive of cutbacks since they could result in dramatic reductions in benefits. Therefore the most commonly-seen approach today is the so-called "best after-tax results" or "best net" approach. In this alternative, the employee pays the excise tax if that would produce a superior after-tax result for the employee. If not, then the employee's golden parachute payments are reduced. This approach is superior to not dealing with the issue at all, since if an employee and the company would both be better off if the employee receives reduced benefits, failure to address the issue doesn't allow for that possibility. And trying to reduce benefits shortly before payment may create other tax problems, such as constructive receipt.

There are some planning opportunities available to reduce or avoid golden parachute payments even once a sale has been agreed upon. If a sale agreement is signed before year-end but does not close until the next year, executives may be able to increase their "base amounts" by accelerating income into the prior year, such as by exercising stock options. Companies on a calendar year will sometimes calculate and pay annual bonuses in the prior year. There may also be an ability to use noncompetition agreements to reduce the amount subject to the golden parachute rules. Any agreements that a key employee may enter into with the acquiror will generally be finalized after the closing.

6. Validation by Independent Compensation Consultants

The company's compensation committee will generally have retained a third party compensation consultant. That consultant should be asked to advise the Board regarding the reasonableness of the golden parachute payment packages, especially those provided to senior executives. The consultant should be estimating the value based on a reasonable estimation of the sale price for the company (i.e., not necessarily the current stock price) so that the Board can best understand the estimated value of the packages under consideration.

7. Single Plan or Individual Agreements?

Some companies prefer to provide golden parachute payments through the vehicle of a plan document that provides for more standardized terms for all participants. The belief is that the use of a plan document deters individual employees from trying to negotiate separate packages and that plans are easier for a company to amend. Executives generally prefer individual agreements because of the greater contractual guarantees that individual agreements generally provide. Much of this debate is more a matter of style and communications, but the company should ensure that whichever approach it takes, the company will retain the ability to re-evaluate the golden parachute packages it provides periodically. One common approach is for individual agreements to have fixed terms (*e.g.*, two to four years) that "roll over" annually after the expiration of the initial term unless the company provides notice that it is terminating the agreement. If such notice is provided, a new arrangement can be implemented.

8. Payments Should Require a Release of Claims

When employment is terminating and the company is making payments in connection with that termination, a release of claims should be obtained. This should also include a covenant not to sue or to support any action by another regarding a released claim. The scope of the release can vary, with many agreements limiting the release to employment-related claims while some releases are designed as a broad general release of all claims. The release should include not only the company, but also all of the company's personnel (officers, directors, etc.) and affiliates (subsidiaries, etc.).

9. Payments May be Tied to Compliance with Restrictive Covenants

In addition to obtaining a release, payment of many golden parachute arrangements is tied to compliance with various restrictive covenants designed to ensure good behavior for a period of time following departure. Here is what we generally see, and what is less common (depending on where the employee is located).

Commonly Seen Restrictive Covenants

- Protection of company's confidential information
- Non-solicitation of employees, and sometimes other service providers
- Non-disparagement of the company

Less Commonly Seen Restrictive Covenants

- Engagement in a competitive business/ non-solicitation of customers/suppliers
- Prohibition on hiring employees for a new business (even if not solicited)
- Regulated contact with the media on matters related to the company

10. Protective springing funding of estimated benefits

Some acquisitions may not be friendly. Employees may rightly be concerned that an acquiror might dispute their entitlement to golden parachute payments, especially if triggered by resignation for "good reason". So in some unfriendly situations, we have seen Boards consider making arrangements to place funds in a segregated trust or escrow arrangement in order to assure employees that sufficient assets will be available to satisfy the company's contractual obligations. Under these circumstances, selection of the person or group to make decisions regarding entitlement to benefits becomes of paramount importance. Common approaches are to engage (by then) former members of the Board or an independent institution. Care should be taken to ensure that the accelerated funding does not trigger income tax for employees before the benefits are actually paid.

Stephen Fackler Michael Collins

UK M&A AND CORPORATE CASE LAW UPDATES

Introduction

There have been a number of recent decisions of the UK courts which are likely to be of interest for M&A and corporate practitioners. This update summarises certain of those decisions which impact and highlight the:

- differences between warranties and representations as a matter of English law and the impact on a claimant's possible remedies;
- scope of warranties and the willingness of the UK courts to potentially consider the parties' commercial intentions when entering into a contract;
- extent to which "good faith" terms will be implied in the performance of English law governed contracts;
- circumstances in which the corporate veil can be pierced; and
- maximum duration of vendor-purchaser restrictive covenants.

The difference between representations and warranties

The High Court decision of Mr. Justice Mann in Sycamore Bidco Ltd v Breslin & Anor[1] considered whether express warranties in a share sale agreement could found an action for misrepresentation. Mr. Justice Mann found that, on a correct interpretation of the contract, the express warranties were only warranties and could not be characterised as representations without specific language making it clear that the warranties were also to be considered as representations. This case highlights how clarity of drafting is of the utmost importance in this context. In particular, all language relating to representations should be excluded from an agreement if that is the intention. Also, the decision confirmed that a properly drafted "entire agreement" clause should specify that claims for innocent or negligent misrepresentation based on language in the agreement are excluded.

1 [2012] EWHC 3443 (Ch)

Legal Background

English law creates a clear distinction between warranties and representations such that:

- A warranty is a statement of fact which in itself is a contractual term. If it is not performed, the person relying on the warranty may have a claim for breach of contract.
- A representation is a statement of fact or opinion relied upon by the other party when entering into the contract. It is normally pre-contractual and not a contract term, although it may be repeated in the contract. If it is false, and relied upon, the person relying on the representation may have a claim for misrepresentation and the contract may be rescinded.

Accordingly, the key differences between warranties and representations are:

- Representations are typically made prior to a contract being entered into, whereas warranties are terms of the contract.
- The remedy for breach of warranty is damages, which are calculated on the basis of the diminution in value of the acquired asset(s). The intention of calculating damages in this way is to put the aggrieved party in the position it would have been had the contract been performed in accordance with its terms. If the warranty is fundamental to the contract, the contract may also be repudiated. A claim for damages for breach of contract is made under common law.
- The remedy for misrepresentation is rescission of the contract and/or damages to put the party that has been misled in the position it would have been in had the contract not existed. A claim for misrepresentation is made under the Misrepresentation Act 1967.

Factual Background

The claimant was a special purpose vehicle formed to acquire the entire issued share capital of Gissings Group Limited ("Gissings") for £16 million pursuant to a share

purchase agreement dated 9 November 2007. The claimant's ultimate shareholders were funds managed by Dunedin Capital Partners Limited (a PE firm). After completion, the claimant discovered what it considered to be accounting errors in Gissings' pre-transaction audited accounts which it had relied upon in determining the valuation and negotiation the sale price. The claimant claimed that these errors had resulted in Gissings' turnover being overstated in the accounts by up to £300,000. No disclosure was made against the warranty that could be relied upon. The claimant claimed against the defendants, who were the selling shareholders of Gissings under the share purchase agreement for breach of an accounts warranty. In the alternative, it was claimed that the warranties were representations and accordingly were negligent misrepresentations under the Misrepresentation Act 1967. The claim for breach of warranty was for £6m and the claim for misrepresentation was £16m as Gissings was said to be worthless following discovery of the accounting errors. The defendants argued that since members of Gissings' board of directors, an MBO team, continued with it and were appointed as directors of the claimant, a defence of actual knowledge existed as those persons had knowledge of the facts, matters and circumstances attributable to the breach.

Key Elements of the Decision

Mr. Justice Mann held that there was a breach of warranty but no misrepresentation, so the contractual remedy of damages would apply. In reaching his decision, Mr. Justice Mann chose to disagree with the decision of the High Court in *Invertec Ltd v De Mol Holding BV [2009]* which provided that warranties could be characterised as representations. The judge's reasoning for holding that the warranties were not capable of being categorised as representations was as follows:

1. There is a clear distinction in law between warranties and representations with each having differing remedies for breach. The draftsman of an agreement is likely to understand this distinction and in the agreement in question this distinction was clear. The words of the warranty clause were words of warranty and not representation. In order for a warranty to be construed as a representation, there needs to be language in the agreement capable of making that clear; it is not sufficient that the subject matter of the warranty is capable of being a representation.

2. The disclosure letter distinguished between warranties and representations. The limitations on liability clearly only referred to the warranties (as defined). If the warranties were representations as well then the limitations would not apply and the sellers would be deprived of the protection afforded by those provisions.

3. There is a timing issue in characterising provisions in the contract as being representations relied on in entering into the contract. If representations are made prior to the contract which are relied upon when the contract is entered into then express provision containing representations should be included in the contract.

4. On the defence of actual knowledge, it was held that the claimant had not acquired actual knowledge of the facts giving rise to the breaches of warranty merely as a result of members of the MBO team who were aware of the relevant facts becoming directors of the claimant. The knowledge could not be imputed to the claimant and more subtle inquiry was required. The relevant directors obtained their knowledge when on the sellers' side of the line in their capacities as directors of Gissings and had not made that knowledge known to the claimant.

The scope of contractual warranties

The UK Court of Appeal recently held in the Belfairs Management case[2] that a warranty in a sale and purchase agreement should be interpreted with regard to all of the background knowledge reasonably available to the parties at the time the contract was entered into. The willingness of the UK courts to potentially consider the parties' commercial intentions when entering into a contract has potentially important implications. Sellers, as well as buyers, must carefully consider whether the warranties adequately cover the key commercial imperatives for the

2 *Belfairs Management Limited v Sutherland & Anor* [2013] EWCA Civ 185

transaction and also consider their approach to disclosure, regardless of the express scope of the warranties, if it is felt that those warranties do not do so. Buyers should continue to ensure that warranties are carefully drafted so as to explicitly cover any specific issues which are particularly important to them in the context of the transaction as a whole.

Legal Background

Historically, the UK courts have been very reluctant to attempt to determine the commercial intentions of contracting parties as an aid to contractual interpretation, particularly if such an approach would be contrary to a literal reading of a contract. However, this decision highlights the circumstances in which the UK courts may adopt a more purposeful, rather than a literal, approach in order to give effect to the commercial intentions of the parties.

Factual Background

Belfairs Management Limited ("Belfairs") had, by way of a share purchase agreement (the "SPA"), agreed to buy a 60 per cent. stake in Waveform Solutions Limited ("WS Ltd") from Matthew and Christie Sutherland (the "Sutherlands") for £2 million. As part of the transaction, Belfairs agreed to provide an additional £600,000 to WS Ltd by way of an interest-free loan, and the Sutherlands agreed to lend WS Ltd £1 million from their sale proceeds by way of a convertible loan and an interest-free loan. The SPA included a warranty that "[WS Ltd] is not a party to any agreement, arrangement or commitment which cannot be readily fulfilled or performed by it on time" (the "Warranty").

WS Ltd, along with seven other companies, had previously been selected to enter into a framework agreement with the UK's National Health Service (the "NHS") (the "Framework Agreement") but, as WS Ltd required a capital injection in order to meet its obligations under the Framework Agreement, it delayed entering into the Framework Agreement until that additional funding (by way of the aforementioned shareholder loans) was secured. The Framework Agreement was signed shortly after the SPA was entered into and required WS Ltd to meet certain specific technical and regulatory milestones within 12 months of signing and, assuming those were met, would afford WS Ltd the opportunity to bid for potentially extremely lucrative contracts with various NHS Primary Care Trusts.

Approximately six months after the SPA was entered into, WS Ltd became unable to meet its obligations under the Framework Agreement and shortly thereafter entered into administration. Belfairs brought a claim against the Sutherlands for, among other things, breach of the Warranty. The Sutherlands argued that the Warranty had not been breached because WS Ltd had not entered into the Framework Agreement at the time that the SPA was signed, and therefore it could not be considered to be an "agreement, arrangement or commitment" of WS Ltd for the purposes of the Warranty. The High Court upheld this view on the basis that when the SPA was entered into the non-binding offer by the NHS to WS Ltd to enter into the Framework Agreement did not subject WS Ltd to any legally binding obligations (including any obligations that could not be "fulfilled or performed by it on time") and accordingly the Warranty could not apply to the Framework Agreement. The High Court also held that in determining whether the Warranty had been breached regard should be had to the subjective assessment of the Warranty by the Sutherlands in determining whether the Sutherlands considered the Warranty to be misleading or inaccurate as at the date of the SPA.

Key Elements of the Decision

The Court of Appeal held on balance that the Framework Agreement should be within the scope of the Warranty as an "agreement, arrangement or commitment" to which the Warranty applied; the construction of the Warranty turned on whether a reasonable person with all the background knowledge reasonably available to the parties at the time the SPA was entered into would regard the Framework Agreement as an "agreement, arrangement or commitment" of WS Ltd, even though at the time the SPA was signed the Framework Agreement had not been formally entered into. Accordingly, on a commercially sensible construction, the Warranty must have been intended to apply to the Framework Agreement. In reaching these conclusions, the Court of Appeal noted that the Framework Agreement "was at the very heart of the commercial deal" and the deal had been structured such that following the entering into of the SPA and the capital injection contemplated by it, the newly capitalised WS Ltd would be able to sign up to the Framework Agreement (and ultimately bid for the contracts with the various NHS Primary Care Trusts).

Implied "good faith" terms in the performance of contracts

In overturning a decision of the High Court, the Court of Appeal in Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (trading as Medirest)[3] refused to imply a term preventing the exercise of a contractual discretion "arbitrarily, capriciously or in an irrational manner". In doing so the Court of Appeal drew an important distinction between the implication of terms where a 'simple' discretion is exercised (as in that case) and situations where the discretion is complex. In addition, the decision builds on recent case law around the interpretation and implication of "good faith" clauses. This case shows that while there is no duty to negotiate in good faith under English law, agreed contractual discretions can bring with them an implied "good faith" duty when they are to be exercised.

Legal Background

The UK courts may imply a term into a contract to fill a gap in the contract's drafting in order to reflect the parties' intentions when the contract was entered into. There are various authorities supporting the implication of a "good faith" term preventing a contractual discretion from being exercised "arbitrarily, capriciously or in an irrational manner"[4].

Whilst there is no general English law duty to perform contracts in "good faith" (except in certain specific relationships), the UK courts have no difficulty in implying such a requirement into commercial contracts by way of established methodology for the implication of terms by reference to the parties' intentions, a principle recently re-enforced in Yam Seng PTE Ltd v International Trade Corporation [2013] EWHC 111 (QB) ("Yam Seng").

Factual Background

In 2008 Medirest entered into a contract with the Mid Essex Hospital Services NHS Trust (the "Trust") for the provision of catering and cleaning services in two hospitals. The Trust argued that its termination rights under that contract were triggered as a consequence of Medirest having accumulated a critical number of 'service failure points'. Medirest contended that the Trust had inaccurately accumulated data pertaining to the calculation of the 'service failure points', and having not corrected the data, was in un-remedied material breach of the contract. The case revolves around two particular provisions:

- Clause 5.8 provided that in the event that Medirest's performance did not meet the required standard (i) 'service failure points' would be incurred, and (ii) the Trust could at its discretion make a corresponding payment deduction.
- Clause 3.5 included an obligation on the parties to co-operate "in good faith" and take all reasonable action as is necessary for the "efficient transmission of information and instructions" and to allow the Trust to "derive the full benefit of the contract".

At first instance the High Court found that the Trust was subject to a term implied into Clause 5.8 requiring it not to exercise its discretion "arbitrarily, capriciously or in an irrational manner" and that the obligation to co-operate with Medirest in "good-faith" extended beyond the specific circumstances referenced in Clause 3.5. The High Court found that both the Trust and Medirest were entitled to terminate the contract. Taking issue with this decision, the Trust took the case to the Court of Appeal.

Key Elements of the Decision

The decision turned on the following two questions:

- Was there a term implied into Clause 5.8 obliging the Trust not to exercise its discretion in an "arbitrary, capricious and irrational manner"?
- What was the scope of the express "good faith" requirement at Clause 3.5?

In considering Clause 5.8, Jackson LJ considered a line of authorities dealing with the implication of terms preventing the exercise of an express discretion in an "arbitrary, capricious or irrational manner" and concluded that such a term may be implied where the discretion involves making an assessment or choosing from a range of options, taking into account the interests of both parties. However, he distinguished the discretion available to the

3 [2013] EWCA Civ 200.

4 *Abu Dhabi National Tanker Co v Product Star Shipping Ltd* [1993] 1 Lloyd's LR 397 / *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287 / *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116 / *JML Direct Ltd v Freestat UK Ltd* [2010] EWCA Civ 34.

Trust on the basis that it did not allow the Trust to decide on how the 'service failure points' or payment deductions were to be calculated and therefore constituted a simple discretion "not to exercise an absolute contractual right". Given that the contract included detailed provisions as to the calculation of 'service failure points' and payment deductions and included an express provision dealing with the consequences of miscalculation, the implication of an additional term was unjustified.

Jackson LJ emphasized that the operation of express "good faith" clauses is heavily dependent on their context. On his interpretation of Clause 3.5 the requirement to act in "good faith" was limited to the specific circumstances outlined in Clause 3.5 and should not be broadened to imply a more general duty to act in such a manner. In essence, the Court of Appeal found that the limited nature of the Trust's discretion under Clause 5.8 prevented the finding of an implied term and therefore removed any question of its breach. Given that there was no such breach and that the duty of "good faith" in Clause 3.5 was to be construed narrowly, the Trust's errors in calculating the 'service failure points' did not constitute a "material" breach of the contract.

Whilst the decision has not fundamentally altered the English law position in respect of the implication of terms or duties of "good faith" the case does raise a number of issues:

1. Applying the distinction drawn by the Court of Appeal in relation to the implication of terms where a 'simple' discretion is exercised versus situations where the discretion is complex may not always be an easy exercise in practice.

2. At first glance the narrow interpretation of the "good faith" clause in this case appears to contrast with the decision in Yam Seng; however, it is clear that this decision turns very closely on the interpretation of the specific provision and that a duty of "good faith" may still be implied where the context justifies doing so.

3. Where a discretion in a contract consists of more than a simple choice of whether or not to exercise an absolute contractual right, it will be "extremely difficult" to exclude an implied "good faith" term.

Piercing the corporate veil

The UK Supreme Court's decision in the VTB Capital case[5] included a unanimous decision (on the element of the appeal that relates to the piercing of the corporate veil; certain other appeals were dismissed by a majority), which upheld the decisions of both the UK Court of Appeal and the court of first instance, that it would be contrary to both previous authority and principle to extend the circumstances where the corporate veil should be pierced. The decision is significant and provides a welcome return to previous methodology and offers greater certainty to the English law of contract founded on the principles of privity of contract and separate corporate legal personality.

Legal Background

It is a fundamental principle of English company law that a company has separate legal personality from its members[6]. However, in certain circumstances a court may "pierce the corporate veil" (i.e. disregard a company's separate legal personality) and attribute its members with the consequences of the company's acts (or omissions), including where "special circumstances exist indicating that [the corporate veil] is a mere façade concealing the true facts"[7]. The principles of when the corporate veil may be pierced have recently been summarized in the Hashem case[8], namely that:

1. Ownership and control of a company are not of themselves sufficient to justify piercing the veil; control may be a necessary, but it is not a sufficient, condition.

2. The court cannot pierce the corporate veil merely because it is thought to be necessary in the interests of justice; in particular, the corporate veil can be pierced only if there is some "impropriety".

3. Finally, the court cannot pierce the corporate veil merely because the company is involved in some impropriety; in particular, the impropriety must be linked to the use of the company structure to avoid or conceal liability.

5 *VTB Capital plc v Nutritek International Corp and others* [2013] UKSC 5
6 *Salomon v A Salomon & Co Ltd* [1897] AC 22
7 *Woolfson v Strathclyde Regional Council RC* [1978] UKHL 5
8 *Hashem v Shayif and another* [2008] EWHC 2380 (Fam)

Factual Background

The VTB Capital dispute concerned allegations of fraud and conspiracy brought by the claimant bank, VTB plc (an English company) against three companies and Konstantin Malofeev (a Russian citizen) in relation the sale of six Russian dairy businesses and three associated business. VTB entered into a facility agreement with Russagroprom LLC ("RAP") (a Russian company) pursuant to which it loaned $225 million to RAP to fund the acquisition of the dairy businesses from the seller, Nutritek (a BVI company). The agreement was governed by English law and was subject to the non-exclusive jurisdiction of the UK courts.

RAP eventually defaulted on the loans and VTB only recovered around $40 million by enforcing the security. It alleged that it was induced to enter into the facility agreement by misrepresentations made by Nutritek (the first defendant) as to the value of the dairy businesses and the fact that RAP was under the common control of the other three defendants: Marshall Capital Holdings Limited, Marshall Capital LLC and Malofeev. Initially, VTB sought to make the Marshall companies and Malofeev liable as joint tortfeasors to the deceit or as parties to the conspiracy to defraud VTB. Subsequently, it also made an application to amend its particulars of claim to include a claim in contract against these three defendants on grounds that the court could pierce the corporate veil of RAP and hold the defendants, as the alleged controllers, liable for breach of the facility agreement. This would allow VTB to rely on the English jurisdiction clause in the facility agreement. The defendants argued that the UK courts had no jurisdiction to hear the claim and that Russia was the appropriate forum for the dispute.

Arnold J at first instance refused permission to amend to add the claims in contract. He held that where a claim of wrongdoing is made against the person controlling the company, it was inappropriate to lift the corporate veil to enable the claimant to pursue a contractual claim against that person. VTB was granted leave to appeal.

The Court of Appeal dismissed all the appeals and upheld the decision at first instance. It held that VTB's contractual claim was not founded on a recognized cause of action and that the court's ability to pierce the corporate veil was limited only to situations where it was necessary to provide a practical solution in specific factual circumstances and where it was just and convenient to do so. Leave to appeal was granted by the Supreme Court.

Key Elements of the Decision

A five strong bench of the Supreme Court dismissed all the appeals. Lord Neuberger gave the unanimous judgment on the piercing of the corporate veil issue; whilst he left open the question of whether there exists any principled basis on which courts can pierce the corporate veil, the decision indicates that the existence of such a principle is recognized in previous authorities and in all leading textbooks on English company law. He cited with approval the test laid down in the Hashem case and in particular that in order to pierce the veil, "it is necessary to show both control of the company by the wrongdoer(s) and impropriety, that is, (mis)use of the company by them as a device or façade to conceal their wrongdoing … at the time of the relevant transaction(s)". On the assumption that such a principle does exist, the Supreme Court notably held that:

1. VTB's case involved an extension to the circumstances where it has traditionally been held that the corporate veil can be pierced and such an extension would be contrary to authority and contrary to principle. Accepting VTB's argument would mean that a person controlling the company could be held liable as if he had been a co-contracting party with the company where the company was a party and he was not.

2. It would be wrong to treat Malofeev as a party to the facility agreement in circumstances where: (i) none of the actual parties to the agreement intended to contract with Malofeev; (ii) Malofeev did not intend to contract with any of those parties; and (iii) Malofeev did not conduct himself or lead any party to believe that he was liable under the agreement. This follows from one of the most fundamental principles of contractual law, namely what an objective reasonable observer would believe was the effect of what the parties to the contract, or alleged contract, communicated to each other by words and actions, as assessed in their context.

3. Extending the principle of piercing the veil in the manner suggested by VTB was not needed or necessary in this case to enable VTB to seek

redress from the defendants. VTB had a claim in tort against Malofeev for any misrepresentations; the corporate veil should not be pierced simply to enable VTB to bring the claim in the UK courts.

Vendor-purchaser restrictive covenants

The High Court has highlighted in Cavendish Square Holdings BV v El Makdessi[9] that it is reluctant to strike down restrictive covenants between a vendor and purchaser on the grounds of duration (for example, of eight years) if such covenant is otherwise reasonable. There is no established case law striking down vendor-purchaser covenants on the grounds of their duration alone. This is compared to those covenants found in contracts between employers and employees where the courts take a much more strict approach to the duration of such covenants.

In addition, this case is a reminder that courts are reluctant to characterise clauses negotiated by lawyers between commercial parties of equal bargaining power, as a penalty (thus making them unenforceable). The construction and enforceability of a provision (even for example, a liquidated damages clause that is not a "genuine pre-estimate of loss") is to be determined according to a "commercial justification" test.

Factual Background

Cavendish entered into a sale and purchase agreement to buy certain shares in a company ("Target") held by the Target's founder (the "Seller") and a third party ("Mr G"). The consideration payable was $147 million, partly payable by way of deferred consideration. The SPA contained put and call options in respect of the remaining shares in the Target that were held by the Seller and Mr G (the "Remaining Shares"). The agreement imposed amongst other things, a non-compete covenant on the Seller and Mr G that lasted for a minimum of 8 years (the "Covenant"). The SPA provided that any breach of the Covenant would release the Buyer of its obligation to pay the deferred consideration. In addition, the Buyer would have the right to acquire the Remaining Shares at a significantly reduced price, based on a net asset value (and thus not accounting for the goodwill of the Target).

9 [2012] EWHC 3582 Comm

After completion, the Seller carried out activities in breach of the Covenant. Cavendish brought High Court proceedings against the Seller for breach of the Covenant, and sought a court determination that the Buyer was not required to pay the deferred consideration and could exercise its option to acquire the Remaining Shares for the reduced price. The Seller argued the Covenant was unreasonable in duration and amounted to an unreasonable restraint on trade. The Seller also argued that the provisions of the agreement relieving the Buyer of payment of the deferred consideration and determining the reduced price for the Remaining Shares, amounted to a penalty. The court rejected the Seller's arguments, and gave a determination in favour of the Buyer and ordered specific performance of the transfer of the Remaining Shares for the reduced price.

Key Elements of Decision

The High Court held the following.

1. There was substantial goodwill in the Target's business, for which the Buyer paid very substantial consideration. The Covenant was intended to protect the Target and its goodwill from the competition of the Seller, and the court held any breach would be material. For a restrictive covenant to be enforceable, it has to be reasonable in the interests of the parties and in the public interest, and go no further than is reasonably necessary to protect a legitimate business interest. In a vendor-purchaser context, the parties are the best judges as to what is reasonable. There were no reported cases where an otherwise reasonable vendor-purchaser restrictive covenant was found to be unreasonable on the grounds of duration (the court noted case law where a restraint of 25 years had been found to be reasonable). As a result, it held courts should be slow to strike down clauses that had been freely negotiated between parties of equal bargaining power. In the circumstances, the minimum 8 year duration was reasonable, such provision having been negotiated in detail by the experienced commercial lawyers of the parties.

2. The provision relieving the Buyer of its obligation to pay the deferred consideration was

to protect the Target's goodwill and adjust the consideration in respect of the Target shares when such goodwill was damaged. It was therefore commercially justifiable and did not, in itself, amount to a penalty. Similarly, the reduced price provisions served a commercial purpose of decoupling the parties as efficiently as possible by reducing the price of the Remaining Shares upon damage to the goodwill. That provision was not, in itself, disproportionate. Taken together, these provisions were not oppressive, and did not in themselves, amount to double counting (however, on the particular facts of the case they were capable of doing so).

3. Case law has modernized the classic "genuine pre-estimate" test, and so the "commercial justification test" is the correct test for determining if a provision is a penalty. There is no longer a dichotomy between liquidated damages and a genuine pre-estimate of loss. The court will instead need to consider whether the provision (i) has commercial justification, (ii) is not extravagant or oppressive, (iii) is not for the predominant purpose of deterring a breach, and (iv) was negotiated on a level playing field.

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- *Proposed new statute will facilitate tender offer structures and eliminate use of top-up options in many circumstances*
- *In many cases, one-step mergers may no longer be the structure of choice*

The Delaware State Bar Association has proposed an amendment to the Delaware General Corporation Law (the "DGCL") that would permit a bidder to undertake an immediate second-step merger following completion of a negotiated tender or exchange offer for a public company's shares that results in the bidder acquiring at least the number of shares of the target company necessary to approve a merger. The proposed amendment, which will appear as a new paragraph (h) of DGCL Section 251, is expected to become effective on August 1, 2013.

Typically, public company mergers are structured as either a one-step merger requiring the filing of a proxy statement and a stockholder vote taken at a stockholders meeting of the target company or a two-step merger consisting of a tender offer for the target company's shares followed by a merger to acquire the shares not tendered. Unless the first-step tender offer results in the bidder acquiring at least 90% of the target company's shares, in which case a "short form" merger without stockholder approval is permitted, the second step requires filing and distribution of a consent solicitation statement or proxy statement for a stockholders meeting where a perfunctory vote can be taken. To eliminate the "long-form" second-step merger, parties often provide for a top-up option exercisable at the conclusion of the tender offer pursuant to which the bidder is issued the number of target shares required for bidder to own 90% of the target's outstanding shares. However,

this option may be unavailable if the target has an insufficient number of authorized and unissued shares. In some cases, the parties have pursued a tender offer and filed proxy materials simultaneously so that, if the bidder does not reach the 90% threshold either in the tender offer alone or through the tender offer and the top-up option, the stockholder meeting can be held quickly after the conclusion of the tender offer. These complicated and circuitous approaches have generated plenty of work for lawyers but, their creativity notwithstanding, deal professionals have long sought a more straightforward approach.

Proposed DGCL Section 251(h) offers such a straightforward approach for Delaware corporations, by making the tender offer process more efficient and logical by eliminating the "long-form" second-step merger if the bidder acquires in the tender offer at least the number of shares necessary to approve the merger. Below are important points to consider in choosing whether to structure a public M&A transaction for a Delaware corporation as a one-step or two-step merger, taking into account new DGCL Section 251(h):

- Section 251(h) is an "opt-in" provision, which means that parties desiring to avail themselves of the provision must explicitly reference it in their merger agreement.

- The primary advantage of a two-step merger as compared to a one-step merger is that the two-step approach can be completed more quickly if the second step is a short-form merger that does not require a stockholder vote. This timing advantage may not be helpful in the case of a merger that will require regulatory approvals subject to an extended process. Because the merger must be consummated shortly after the expiration of the tender offer, the tender offer necessarily must be conducted near the expected closing date which, in the case of a long period between signing and closing due to regulatory review, could be many months after execution of the merger agreement. In a situation where a lengthy regulatory approval process is expected, the acquiror may prefer to employ a one-step structure, such that the target could obtain stockholder approval well in advance of the expected closing date, thereby cutting off the fiduciary out for the target's board of directors.

- To take advantage of Section 251(h), the acquiror cannot be an "interested stockholder" (as defined in Section 203 of the DGCL). This prohibition applies regardless of whether the target corporation has waived the Section 203 takeover defense and regardless of whether the target corporation's board has pre-approved the bidder's acquisition of shares. As a result, Section 251(h) is only available for true third-party transactions.

- Acquirors will often seek tender and support agreements from significant stockholders of the target. These agreements, which provide assurance to the acquiror that large stockholders of the target will tender their shares in the offer, are typically pre-approved under Section 203 by the target's board of directors. However, if these agreements would otherwise cause the acquiror and the supportive stockholders to be considered a group for Section 203 purposes, the acquiror may become an "interested stockholder," which would render Section 251(h) unavailable for the transaction. A potential work-around is for the tender and support agreements not to be executed and delivered until after the target's board of directors approves the merger agreement, although an acquiror may not want to wait until so late in the process to reach an understanding with major stockholders of the target regarding their support of the deal. In addition, if agreement on the terms of the tender and support agreements has been reached prior to the target board's approval of the merger agreement, but the tender and support agreements are not executed and delivered until after execution and delivery of the merger agreement, the acquiror may nevertheless qualify as an "interested stockholder" by virtue of a pre-existing understanding with the stockholders of the target regarding their agreement to support the transaction.

- In financial sponsor transactions, management often "rolls over" its equity interests in the target company into equity of the sponsor's acquisition vehicle. To ensure compliance with the SEC's "best price rule" (which requires that the same consideration per share be paid in tender offers) in acquisitions structured as all-cash tender offers, the management rollover transaction may be effected in the second-step merger rather than the tender offer. However, Section 251(h) requires that the untendered shares that are subject to the second-step merger must receive the same consideration as the shares tendered in the tender offer. As a result, the management rollover transaction would not be permitted in the second-step merger in a Section 251(h) transaction.

- Historically, ISS and Glass Lewis have not issued recommendations in two-step transactions. However, this practice may change if a significantly greater number of transactions utilize the two-step structure in light of Section 251(h).

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