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Inside M&A

Insights into legal developments affecting mergers and acquisitions.

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The Top Five Environmental Traps in M&A Transactions

Because environmental laws and regulations can impose substantial operating costs and liabilities, it is very important to flag and address environmental issues in M&A transactions. Such issues include operating costs and liabilities associated with current and past operations, as well as cleanup costs and liabilities arising from site contamination. In addition, a forward-looking analysis may be necessary if the industry involved in the transaction is targeted for increased regulation. Some of the pitfalls you can encounter, and how to avoid them, are summarized below.

1. Understand the Deal and the Client's Goals

First and foremost, it is necessary to understand the basic parameters of the deal and the client's goals and expectations. In addition to determining whether the transaction involves a stock or asset purchase, you need to know whether the real property involved in the deal is leased or owned, if the relevant environmental permits and approvals are available for review, what environmental litigation and enforcement actions have occurred or are ongoing, and whether there are engineering reports to provide such baseline information, as well as data about historic uses of the real properties involved in the transaction. Where the information is less than complete, you need to make sure that the client understands the risks that could exist, whether as the buyer or seller, if the "unknowns" turn out to be material.

2. Remember the Limits of Your Expertise

Unless the situation is very unique, it is important to remember that you are acting as a lawyer in the transaction, and not as a technical consultant. Understand the limits of your role and act accordingly. Where you need technical expertise, find the appropriate consultant(s) in a timely fashion so that you are not driven by expediency as opposed to merits in identifying and retaining such assistance and in making decisions with the benefit of that technical input.

3. Information is Everything

Environmental due diligence is very important in order to represent the best interests of your client, regardless of whether you represent the buyer or the seller. In fact, due diligence that meets the requirements of relevant state and federal laws and regulations may provide a buyer with protection from most cleanup responsibilities for historic contamination. In order to obtain such protection, a so-called "Phase I report" that includes property visits and records review will generally be necessary.

Where your client is the buyer, you need to ensure that the client understands the compliance status and associated liabilities of the business and properties being acquired, and whether there is historic contamination of concern. If the data provided by the seller is complete and comprehensive, the investigation may end after review of such information, especially if it includes Phase I reports and any additional investigation required as a result of those reports. However, it may also be advisable to review management presentations describing company operations and future plans. In addition, you may need to conduct some online research about the business and relevant litigation and enforcement actions, or to supplement the information provided about past uses of particular properties. This supplemental investigation may encompass nearby properties that could contaminate the properties involved in the transaction, or perhaps extend to regulation of the industry involved in the transaction where statutory or regulatory changes are on the horizon.

If you are serving as the seller's counsel, you should ensure that the data provided by the seller adequately identifies the environmental issues associated with the business and its operations, and of the properties encompassed by the transaction. That would include the operating permits and the conditions that they impose, as well as information about historic uses and knowledge of historic contamination, whether originating onsite or offsite. If the seller is aware of offsite contamination that could be migrating onto the property, then such knowledge needs to be conveyed in the appropriate manner, particularly if failure to do so would saddle the seller with responsibility to address that contamination or lead to arguments that could undo the deal.

4. Keep State Requirements and Jurisdiction in Mind

It is easy to focus on federal regulatory requirements and ignore state programs. But those state programs can be even more stringent than their federal counterparts and thus very important in any assessment of regulatory requirements affecting company operations and liabilities. In addition, it is important to remember that contract terms such as environmental representations and indemnities may well be decided under state law. For example, even where the contract language may preclude the seller's liability under a federal statute such as the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), a buyer may still have common law claims under state law provisions and principles, and the statute of limitations for such claims will also depend upon the relevant state law.

5. Beware of Vague Clauses

Failure to clearly state which party to a deal has liability for particular issues, including unanticipated cleanup liabilities in the future, can lead to results that the drafters may have never envisioned. "As Is" language in contracts has been subject to particular scrutiny, and such clauses must be especially clear to withstand judicial scrutiny. In a number of lawsuits, the courts have used dictionary definitions to determine the meaning of particular contract terms where the judge concluded that the intent of the drafters was not sufficiently clear.

While this can happen where both parties thought they had specifically stated their intention, it can be even more of an issue where those parties cannot reach agreement and opt for language that is more vague. In such a situation both parties to the transaction may find that the court's interpretation is quite different from either of theirs. In addition, a court may consider what earlier drafts of the agreement covered. For example, if an earlier draft included a specific clause (such as an indemnification provision or an "As Is" clause) that was later removed, the earlier draft might be used as evidence of what came off the table during the negotiation process.

The foregoing "traps" are of course not the only ones you can encounter in a particular transaction. However, timely due diligence and continued dialogue between and among members of the deal team can go a long way toward resolving the issues that may arise.

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The Top Five Tax Traps in M&A Transactions

The tax consequences of acquisition and disposition transactions can dramatically impact deal value. Often the potential tax issues can be resolved in a manner that is consistent with the intention of the parties without changing the economics of the deal. If some of these tax issues are not addressed, however, the parties may not obtain the benefit they had bargained for even though it may have otherwise been possible. This puts a premium on the involvement of tax advisors from the outset of a transaction. Although one rarely wants to see tax be the "tail that wags the dog" in a deal, tax issues can present significant economic opportunities or costs that may often warrant tweaking or changing the deal structure to accommodate these issues.

1. Failure to Solicit Tax Advice at the Letter of Intent Stage

Although not binding, the terms of the letter of intent entered into by the parties in the early stages of the acquisition process can put one of the parties in a superior bargaining position as it relates to which party bears the burden or reaps the benefits of the tax costs and benefits associated with a transaction. Too often, a client does not engage its outside advisors (or significantly limits the involvement of its outside advisors) until after a letter of intent is signed. The failure to include the tax advisor at this early stage can mean lost dollars to the seller or additional cost to the buyers.

For example, if the target is an S corporation, in most cases the buyer should be able to secure the benefit of a tax basis step-up for federal income tax purposes without a material increase in the taxes payable by the seller with respect to the sale. However, if the buyer is not well-advised, the letter of intent may simply indicate that the buyer will acquire the stock of the target for the agreed-upon consideration. If, after the letter of intent is executed, the buyer recognizes that a tax basis step-up can be achieved with little or no tax cost to the seller, the buyer may request that the transaction be converted to an asset purchase or that a Section 338(h)(10) election be made by the parties. At this point, the seller has the leverage and can demand additional consideration from the buyer in exchange for the tax benefits that such a structure would provide.

2. Section 197 Anti-Churning Rules

When the acquisition of a business is structured for income tax purposes as an asset purchase (*i.e.*, an asset purchase in form or a stock purchase coupled with a Section 338(h)(10) election), the buyer usually has bargained for the tax benefits that accompany such a transaction—namely, the ability to tax effect the purchase price by depreciating or amortizing the premium paid for the assets, which premium is usually attributable to the goodwill and going concern value of the acquired business. If the business being acquired was in existence on or before August 10, 1993 and, before or after the transaction, the seller or a related party owns, directly or indirectly, greater than twenty percent of the equity of the buyer – which may be the case, for example, if the deal calls for the seller to receive "rollover equity"—the goodwill and going concern value of the target (as well as other Section 197 intangibles) may not be amortizable by the buyer. As a result, the buyer will not obtain the tax benefits that it anticipated and paid

for as part of the acquisition. The economic benefit that is lost can amount to as much as 20-25 percent of the purchase price depending on the discount rate used to calculate tax benefits and other factors.

Moreover, if the acquirer is a limited liability company or the corporate acquirer is owned by a limited liability company, and the seller will have an interest in the limited liability company following the acquisition, the anti-churning rules can be an issue even where the seller owns less than twenty percent of the limited liability company. It is therefore critical that any transaction that calls for the seller or a party related to the seller to obtain (or retain) an equity interest in the buyer in connection with the acquisition, the buyer should closely study whether the anti-churning rules could be applicable. A failure to do so can result in a significant – and perhaps needless—reduction in the buyer's after-tax cash flow and adversely affect the purchase price payable by a subsequent buyer of the business.

3. Qualified Stock Purchase Failure

As an alternative to structuring an acquisition as an asset purchase in form, a buyer can realize the tax benefits of an asset purchase by structuring the acquisition as a stock purchase and making a Section 338 or Section 338(h)(10) election in connection with the transaction (the latter requiring the consent of the seller and being limited to target corporations that are S corporations or subsidiaries of a consolidated group). In order to be eligible to make a Section 338 or 338(h)(10) election, the acquisition must constitute a "qualified stock purchase", one of the requirements of which is that 80 percent or more of the target corporation's stock be acquired in a twelve-month period by "purchase". For this purpose, "purchase" excludes transactions on which gain or loss is not recognized, including exchanges that qualify for tax-free treatment under Section 351. Frequently, when a new corporation is being organized to acquire the stock of the target corporation, one or more of the sellers may "roll over" a portion his or her target corporation stock for stock of the new corporation. When less than 20 percent of the stock of the new corporation is received by the seller(s) in the exchange such that greater than 80 percent of the stock is acquired for cash, it would appear that the requirement that 80 percent or more of the stock of target be acquired by purchase would be satisfied. However, if any seller receives any stock of the new corporation (even one percent) in a transaction that qualifies as a Section 351 exchange, the acquisition will not constitute a qualified stock purchase and will be ineligible for a Section 338 or 338(h)(10) election.

The solution here is to structure the transaction so as to intentionally not qualify as an exchange under Section 351. Although this will undoubtedly have ramifications to the sellers (who may otherwise have been expecting to not have to recognize gain currently with respect to their rollover equity), the failure to obtain a step-up in basis in the assets of target corporation and consequently, the inability to tax-effect the purchase price (through depreciation and amortization deductions) may have an even larger negative impact on the buyer.

4. Acquisition of Shares of "Loss Stock" from Consolidated Group

A recent overhaul of the so-called "loss disallowance rules" changed the rules that apply when a buyer acquires the stock of a target company out of a U.S. federal consolidated group in a transaction in which the seller recognizes a loss. Prior to the change in the law, any limitation on the recognition of that loss for tax purposes would impact only the seller; the buyer was unaffected. However, under the new rules, if the buyer acquires shares of stock from a consolidated group that constitute "loss stock" (*i.e.*, the consideration paid for the stock is lower than the selling consolidated group's tax basis of the stock), absent a special election made by the seller, the tax basis in the assets of the target corporation (as well as other target corporation tax attributes) may be subject to reduction in an amount equal to some or all of the seller's loss.

As a result, in all stock purchase agreements where the seller is a member of a U.S. federal consolidated group, the buyer should insist on a representation that none of the acquired shares are "loss shares" and, to the extent any of the shares are "loss shares", the buyer should insist on a covenant that would require the seller to make the election that would, in lieu of reducing the target corporation's tax basis in its assets and other tax attributes, cause the loss recognized by the seller to be reduced. In situations where the tax benefit to the seller from the loss is greater than the tax cost associated with the reduction in tax attributes, the seller should compensate the buyer for this tax cost.

5. Phantom Income/AHYDO Rules

Whenever an acquisition is financed, in part, through borrowing, and interest on the loan is not required to be paid at least annually (or there are warrants or other equity instruments issued to the lender in connection with the loan), the parties should consider the potential application of the original issue discount (OID) rules. Generally, subject to certain *de minimis rules*, if interest on a debt instrument is not required to be paid at least annually—*i.e.*, the interest simply accrues automatically or accrues at the option of the borrower—the interest income and interest expense will be recognized for tax purposes notwithstanding that the interest is not actually paid on a current basis. This means that the holder of the debt instrument will recognize taxable income without receiving

any cash—*i.e.*, the holder recognizes so-called "dry income" or "phantom income." Although the phantom income resulting from the characterization of a debt instrument as an instrument issued with OID is generally manageable (either because the holders are tax-exempt or that portion of the interest needed to cover taxes can be paid on a current basis), in certain circumstances, there are special rules that may result in the borrower's tax deduction for the interest/OID being deferred or disallowed.

Specifically, the tax rules defer and, in some circumstances, permanently disallow deductions for OID on certain applicable high yield discount obligations (AHYDOs). An AHYDO is defined as a corporate debt instrument that meets three requirements. First, the debt instrument must have "significant OID." Second, it must have a term exceeding five years. Third, it must have a yield to maturity that is at least five percentage points above the applicable federal rate (AFR) in effect for the calendar month during which the debt instrument is issued. A debt instrument is treated as having significant OID if, at the end of the first accrual period following the fifth anniversary of the issuance of the debt instrument (and at the end of each subsequent accrual period), an amount greater than one year's worth of OID (the yield to maturity multiplied by the issue price of the debt instrument) can remain unpaid.

Where warrants or other equity-type instruments are issued along with the debt instrument (*i.e.*, as part of an investment unit), there is a greater potential for OID and classification of the debt instrument as an AHYDO because the issue price of the debt instrument will be reduced by any value attributable to this equity thereby reducing the issue price and creating a greater spread between the instrument's stated redemption price at maturity and its issue price—thus creating more OID.

Advance planning can often neutralize the effect of these rules without significantly changing the business deal. By simply adding a provision to the debt instrument that requires (i) all accrued but unpaid OID (in excess of one year's worth) to be paid on the first interest payment date following the five year anniversary of the issuance of the debt instrument and (ii) all interest thereafter to be paid on a current basis, the debt instrument can escape classification as an AHYDO. Of course, this change has the potential for real, economic consequences which should not be minimized. However, where, as is frequently the case, the deal contemplates this debt being refinanced before the five-year anniversary (or the borrower is comfortable that a refinancing can be negotiated at that time), the borrower can avoid having its interest/OID deductions deferred or disallowed. In this regard, it should be noted that a debt instrument is tested for AHYDO classification at the time it is issued and is based on when payments on the debt instrument are unconditionally obligated to be paid. If a debt instrument is characterized as an AHYDO, the borrower's interest/OID deductions are subject to the rules regarding deferral or disallowance even where the borrower actually pays the interest on a current basis.

Conclusion

The foregoing are just a few of the many tax issues that can arise in any deal. If they are spotted early enough, most tax issues can be addressed with relatively inconsequential structural changes to the deal and/or creative planning without changing the underlying business deal. However, if the opportunity to address the tax issues is missed, there are often material economic consequences to one or more of the parties. To the extent that there are tax costs inherent in the deal that cannot be ameliorated through creative planning, the parties need to address how such costs will be shared among the parties; otherwise, the burden of these tax costs may be borne by the wrong party.

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The Top Five Employee Benefits and Executive Compensation Traps in M&A Transactions

In M&A transactions, many lawyers (and clients) assume that employee benefits issues are tangential to the overall business deal and will "work themselves out" after the deal closes. However, employee benefit plans can represent significant liabilities that may affect the purchase price in any transaction. In addition, a smooth transition for employees can be a key component of the success for many transactions. The following are the five most frequent employee benefits and executive compensation issues that can materially affect a transaction and should signal the need for special attention by the parties most adversely affected.

1. Pension Plan Obligations

Single employer defined benefit pension plans often carry significant unfunded termination liabilities that can adversely impact the acquirer's balance sheet. In addition to the potential liabilities represented by unfunded benefits liabilities, the effect of required minimum funding contributions on a target's cash flow can be significant. Potential buyers should also be mindful about acquiring plans that are so under funded that they are subject to benefit restrictions under Section 436 of the Internal Revenue Code. These restrictions may be particularly burdensome in the context of the acquisition of a cash balance plan or other defined benefit plan that offers a lump sum distribution option, which may be restricted. Typically, where assumption of single employer defined benefit pension plans cannot be avoided, the buyer should insist on a purchase price adjustment in the amount of the unfunded benefits liability measured on a basis agreed upon between the parties.

Furthermore, unfunded termination liabilities and annual minimum funding contributions are joint and several liabilities of the "controlled group" of the plan sponsor. The joint and several liability rule is particularly important when dealing with private equity or venture capital funds. If the deal is structured so that the private equity or venture capital fund will own 80 percent or more of the target, then the entire fund can be part of the target's controlled group and jointly and severally liable for the target's defined benefit plan liabilities.

Finally, multiemployer defined benefit pension plans (sponsored by union-affiliated trust funds and maintained pursuant to previous collective bargaining) can assess significant liabilities against employers that cease participation in such plans (referred to as "withdrawal liability"), in accordance with complicated federal and union rules. This potential withdrawal liability should be an important due diligence item in an equity transaction. As with single employer defined benefit pension plan liabilities, multiemployer defined benefit pension plan liabilities are also joint and several liabilities of the entire controlled group. Finally, in an asset transaction, withdrawal liability is automatically triggered and assessed on the asset seller unless the buyer agrees to certain statutory language regarding the buyer's commitment to continue contributions to the multiemployer plan and, in many cases, post a bond in the amount of the current withdrawal liability for a period of five years. In such situations, withdrawal liability will not be immediately assessed against a seller, but the seller will remain secondarily liable.

2. Retiree Welfare Benefit Obligations

Many companies subsidize health and life insurance benefits for retirees (and their dependants) after the employment relationship terminates. Such retiree welfare benefit obligations frequently are partially or wholly unfunded and any "FAS 106" liability associated with the plan must be reflected on the company's balance sheet. Many companies have seen retiree welfare benefit plan liabilities spiral out of control.

The most significant issue with respect to retiree welfare liabilities is the target's ability to reduce or terminate such liabilities in the present or future, which generally hinges on whether the target has reserved its right to unilaterally modify such benefits in the governing documents – a topic which has been the subject of significant class action litigation over the last twenty years. Any time retiree medical benefits are provided, due diligence should be performed to determine whether such benefits are unilaterally terminable by the target. If not, a purchase price adjustment for the buyer may be warranted.

3. Treatment of Defined Contribution Plans

Although defined contribution pension plans do not carry the significant liabilities associated with defined benefit pension plans, they frequently present issues in a transaction. In an equity sale, the defined contribution plan will enter the buyer's controlled group and, after a brief transition period, all defined contribution plans in the controlled group are required to be tested together for nondiscrimination purposes. In addition, once a seller's 401(k) plan enters the controlled group, it can be difficult to fully terminate that plan and move a seller's employees into a buyer's plan. Further, some defined contribution plans contain onerous in-service distribution options that must be preserved if such plans are merged into a buyer's defined contribution plan. In an equity sale, often a buyer will request that a seller terminate any 401(k) plans immediately prior to closing. In an asset sale, a buyer can avoid these issues by not assuming the defined contribution plans. From a seller's perspective, the administrative burden of terminating or retaining the defined contribution plans, should be considered before an agreement to terminate or retain is reached with the buyer.

In any transactions in which the target defined contribution plans contain target stock as an investment fund, special considerations arise with respect to the valuation of the stock in the transaction and the fiduciary liability associated with maintaining the stock as an investment option.

Finally, in asset sales where the buyer is not assuming the target defined contribution plan, the treatment of participant loans

under the target defined contribution plan can be problematic. Many buyers' plans' refusal to accept a rollover of outstanding participant loans from the seller's plan can result in seller's former employees (transferred to the buyer) being held in default on their outstanding loans from seller's plan, with adverse tax consequences to the former participants (the buyer's new employees). This is a matter for due diligence, negotiation and resolution before a purchase agreement is signed.

4. Executive Compensation Issues

In both asset and equity transactions, the treatment of equity plans, change in control agreements and other nonqualified deferred compensation arrangements can be the subject of significant negotiation. In addition to questions of compliance with the Internal Revenue Code's complex Section 409A, if the transaction triggers a change in control or a separation from service for the executive, executives can find themselves in possession of substantial payments earlier than desired, and the often unfunded nature of such plans and arrangements (with no associated "rabbi trusts") can result in significant payments being required from the target's general assets. Due diligence with respect to such plans, should focus on the terms and triggering payment events under such plans. Since noncompliance with Section 409A of the Code can result in substantial excise taxes being assessed upon executives, due diligence with respect to such plans should also focus on compliance with applicable law.

Finally, in certain change in control transactions, "parachute payments" to executives in excess of allowed payments under Internal Revenue Code Section 280G can result in non-deductibility by seller and substantial excise taxes assessed against executives. Shareholder approvals of said payments (if feasible) may preserve the corporate deduction and keep executives from incurring the excise taxes. All employment agreements and change of control agreements should be evaluated to determine if Section 280G issues are involved.

5. International Plans

Many transactions raise issues regarding the retention of employees and assumption of employee benefit plans in foreign jurisdictions. Foreign employee benefit and employment laws are often highly protective of a seller's employees and significantly different from comparable laws in the United States. Importantly, in some foreign jurisdictions, purchasing assets will not insulate a buyer from employee benefits liabilities nor from obligations to hire (or negotiate with employee representatives regarding hiring) large numbers of the target's employees. Thus, in any multi-jurisdiction transaction, thought should be given to the retention of local counsel in foreign jurisdictions with a significant number of employees.

These and other significant benefits-related issues can arise in the course of M&A transactions and, if overlooked until after the transaction closes, can cause substantial adverse consequences for the buyer or seller, such as restricted cash flow, and no longer avoidable costs, taxes and penalties.

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The Top Five Intellectual Property Traps in M&A Transactions

In M&A transactions, many lawyers assume that intellectual property (IP) rights will automatically transfer with the purchase and that IP issues can be cured by general representations and warranties. While getting strong representations and warranties covering intellectual property is useful, relying on a breach of representations and warranties as the only remedy to protect the covered IP can doom the deal to failure or lead to unexpected surprises after closing, including requiring significant changes to future business plans and opportunities. If the target's IP rights are important to the ultimate deal, then those IP rights must be investigated thoroughly in the due diligence and fully understood.

A due diligence investigation into a company's intellectual property assets is essentially a methodical audit which will cover at least the following main areas:

- Patents
- Know-how

- Copyright
- Trademarks
- Infringements
- Licenses and collaboration agreements

Failure to examine these during due diligence in a manner appropriate to the deal at hand can lead to reevaluation, repricing or structural changes of the transaction.

For example, Volkswagen outbid BMW in 1998 to buy Rolls Royce and Bentley and their British factory from Vickers PLC for $917 million. But an odd twist in the deal allowed the Rolls-Royce aerospace company to sell rights to the ROLLS-ROYCE trademark to BMW out from under Volkswagen for $78 million. Thus, after the deal closed, Volkswagen did not have the rights to use the ROLLS-ROYCE mark. Only after a separate deal was made with BMW to avoid litigation, did Volkswagen gain the ability to manufacture a trademarked ROLLS-ROYCE car.

Thus, IP due diligence in an M&A transaction should not be overlooked and should be undertaken early in the process. The following are five common IP issues that may impact M&A transactions.

1. Target Does Not Actually Have the Critical Patent Rights

A target company may not actually own the IP rights that it represents that it owns. This may be due to a failure to update the title through corporate name changes or lien releases, or a failure to ensure that employees have properly assigned their rights to IP assets developed with company resources to the target. This latter situation is particularly problematic. For example, under U.S. patent law, each joint inventor has the right to use and to license patented technology to a competitor without accounting to the other owner in the absence of an agreement to the contrary. As a result, a non-assigning employee can license a key competitor of the buyer (and even keep the royalties) without notifying the target. The problem can be more acute in the case of an independent contractor, who may not have an obligation to assign rights to the target. It is therefore important to review contractor agreements related to any IP relevant to the transaction to confirm that the agreements address ownership of any IP created by the contractor.

Trademarks must be evaluated in terms of their goods, services and countries of registration to confirm that they cover the buyer's intended uses in intended markets. Certain countries recognize common law trademark rights, based on use of a mark, while other jurisdictions give priority to the first party to file a trademark application, regardless of use. Internet domain names are subject to fewer formalities, but must be investigated as well. Domain name registrations may expire and, if expired, the domain names can be bought by anyone. It is also important to confirm that important domain names are owned by an entity relevant to the transaction, as opposed to an information technology (IT) professional within the company, a licensee or another entity.

2. Prior Agreements Limit IP Rights

Sometimes, the target's IP rights may be subject to prior agreements that restrict their use in other markets or fields of use. The target may have existing licenses or agreements with respect to some or all of its IP rights. For instance, the target may have granted a third party exclusive use in a key field of use, territory or patent, which may limited the buyer's full and expected use of the IP rights.

For example, when the Clorox Company purchased the PINE-SOL business and trademark from American Cyanamid in 1990, Clorox planned to leverage the strength of the PINE-SOL mark into other products. Clorox purchased the PINE-SOL assets and mark subject to a prior 1987 agreement that Cyanamid had entered into with the owner of the LYSOL trademark to settle a trademark dispute years earlier. That prior agreement restricted Cyanamid (and subsequently Clorox) from expanding the use of the mark beyond the PINE-SOL pine cleaner. Clorox tried to void the terms of the settlement agreement through litigation, but was unsuccessful.

Licensors of intellectual property may argue that a merger in which a licensee does not "survive" as a separate corporate entity may void the license – even if the license agreement contained no prohibition against merger, acquisition or transfer. This argument is based on an arcane line of federal cases holding that patent licenses are not assignable unless expressly made so. More recently, some federal courts have extended this rule in ways that affect corporate mergers, and have found, in effect, that certain mergers can constitute transfers that void patent licenses. This is especially problematic in an acquisition of a licensee.

Additionally, in certain instances in which the U.S. government has provided funding to an entity (usually a nonprofit, university or small business), the U.S. government may retain certain rights to any relevant patents developed from that research, and any subsequent grants relating to those rights (*e.g.*, a license or acquisition) will remain subject to the government's retained rights. These government "march-in" include the right to license the invention to a third party, without the consent of the patent holder or original licensee, where it determines the invention is not being made available to the public on a reasonable basis.

3. Target is Subject to Pending/Threatened Infringement Claims

No buyer wants to buy an expensive IP-related lawsuit through an acquisition. Any potential litigation or enforcement risks must be assessed and independently analyzed, including evaluating potential indemnifications. Although others exist, two primary areas for inquiry in this context include potential patent infringement and copyright liabilities.

For potential patent liability issues, a purchaser does not want to spend a great deal of time and money to acquire rights that it will not be able to exploit because of third party's potential infringement lawsuit. Potential litigation and enforcement risks may be identified through the target's legal opinions, cease and desist letters, freedom to operate studies and similar materials, which should be requested and analyzed in the due diligence process.

As to open-source software, the GNU General Public License governs a large number of open-source products. Open-source code can only be tightly integrated into other open-source products, and a condition of using the code is that the user also publishes its modified version of the code to the public. The Free Software Foundation enforces the GNU General Public License. This can be problematic in an acquisition, especially when the software is a valuable piece of the assets being acquired. There have been instances where an acquiree has been sued by the Free Software Foundation after acquiring a company that had allegedly incorporate open-source code into its software. In at least one instance, the acquirer had to release the acquired software to the public as a result. Open-source liability can kill a deal and affect the value of a transaction. In the absence of insurance, some companies will accept a reduction in deal price.

4. Significant Barriers Exist to Exploitation of the Technology

With regard to patents and the ability to exploit the acquired patented technology, significant barriers may exist. Third parties may have blocking IP rights that prevent the buyer from exploiting the target's IP or expanding the business as planned. Sometimes, this risk is not specifically known even to a target. Thus, the buyer's freedom to operate often should be analyzed before completing the transaction, to make sure that the buyer will be able to use the assets purchased as intended in the conduct of the business operations, or as proposed to be used according to the buyer's future plans. A freedom-to-operate analysis should be performed, which is an assessment of whether making, using sale, offering to sell or importation of a product in the U.S. will infringe any third-party patents.

If third party IP rights are identified that may block or limit the buyer's use of particular IP rights, and a meaningful design-around is not possible, then it may be necessary to license or acquire ancillary rights to such third party blocking IP rights. Alternatively, the target could seek to invalidate the blocking IP at the United States Patent and Trademark Office (*e.g.*, through a reexamination) or in a court. The inquiry is more complex when pending claims are published yet not issued, so the inquiry not only requires construction of the claims and infringement analysis, but also estimation of whether the published claim(s) will issue. Evolving application of infringement under the doctrine of equivalents and other changing legal standards through judicial decisions only adds to the complexity and cost of the analysis.

Of course, this still leaves unknown barriers to the exploitation of technology. Included in this category are issues such as unpublished patent rights that could block a buyer, misappropriation of technology, reverse engineering by competitors who have then patented improvements to a target's trade secrets or even competitors who independently discover trade secrets and patent them, and the like. To the extent these can be explored, it is wise to do so. However, there are risks in any deal, and wise IP counsel can consider the impact of potential unknowns based on the industry and technology involved in the contemplated transaction.

5. Target's IP Rights Are Encumbered by Liens

IP rights may also be encumbered by liens. To record and perfect a lien against both patents and trademarks in the United States, Uniform Commercial Code (UCC) filings need to be made. Although not legally required, most lenders also record the security agreement in the U.S. Patent and Trademark Office (USPTO). Under U.S. copyright law, however, only a lien recorded in the U.S. Copyright Office will perfect a security interest in copyrights. Due diligence should include reviewing reports from all of the applicable filing offices.

In sum, early and comprehensive IP due diligence in M&A transactions is important because it can lead to a reevaluation, repricing or restructuring of the proposed transaction.

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The Top Five Real Estate Traps in M&A Transactions

In the myriad M&A transactions, for the technology company, hospital chain, pharmaceutical company or consulting firm, the M&A professional's thoughts turn to supply contracts, union and pension obligations, intellectual property, key executives, debt levels and, of course, earnings. And then someone will pipe in with a "what about the real estate?

Well, what about the real estate? Other than in the transaction in which the real estate is a key asset (for example, in a transaction relating to shopping malls, a restaurant chain or a hotel portfolio), real estate issues are often an afterthought in most corporate acquisitions or mergers. But even the company with foreign suppliers and outsourced distribution usually has a physical office somewhere.

Although real estate does not drive the vast majority of M&A transactions, inattention to real estate issues can lead to delays in closings, increased costs and, maybe most unnecessarily, stress and annoyance. Following are a list of five real estate issues for the acquirer to consider in any M&A transaction (and for the target to consider so that it can anticipate issues that may be brought up by the acquirer):

1. Involving Real Estate Lawyers in the Early Stages

Real estate issues should not be the tail wagging the dog – involve real estate professionals or attorneys early in the due diligence process to avoid unpleasant surprises later on. Consider whether the target's locations or offices are leased or owned. Different concerns based on the type of real estate interests held may potentially drive some aspects of transaction structure, particularly in an asset deal.

For example, does the target in an asset (as opposed to stock) deal have mortgage debt on owned property which might be separate and apart from corporate level financing? If so, might the debt be assumed, or should it be wrapped into acquisition financing?

In addition, sometimes the seller or its affiliates lease property to the target under sweetheart deals (for the seller or affiliate landlord). If that is the case, a new lease or amendment to the existing one may need to be negotiated to make it appropriate for an arm's-length transaction.

2. Leases and Change of Control

Chances are that the target is going to occupy or use leased property – be it office space, a distribution center or a manufacturing facility.

There are many reasons to analyze the leased property of the target – to check expiration dates, rent step-ups, renewal terms, whether the landlord has any lien on collateral – but perhaps the most significant issue arising when the target leases property is whether the assignment of the lease in an asset purchase, or acquisition of the target in a stock or equity acquisition, requires the landlord's consent pursuant to the terms of the lease. A straight lease assignment will often require consent of a landlord. There may be certain requirements regarding the transferee, such as that the transferee have a good reputation in the business community or that it have a specified minimum net worth. In addition, even in a merger or stock acquisition, a lease may deem a "change in control" of the tenant to constitute an assignment that requires the landlord's consent.

Based on the language of a particular lease, and the importance of the property involved to the target's business, there may be a need to structure around a landlord consent requirement (perhaps with a sublease from the seller) to avoid a default under a lease in the case where there are doubts about the ability to obtain (timely or at all) landlord's consent.

At the very least, analyzing the provisions in the leases early allow time to address any potential issues.

3. Environmental Liability

This item deserves its own stand-alone article, and is not likely to be overlooked when the target is an energy company or industrial manufacturer, but environmental issues may lurk even in a transaction where it might not seem apparent. As a general rule, environmental site assessment reports are recommended for all properties save space in office buildings. If there have not been recent reports prepared, it makes sense to order new reports early, as they may take several weeks or more to obtain.

Both federal and state regulatory frameworks may come into play. Many states require seller disclosure to the purchaser or a governmental agency when a property with environmental contamination and/or historical or present uses of hazardous materials are involved.

4. Transfer Taxes

Transfer taxes are not issues in every transaction, but state, county or local transfer taxes on the conveyance of real property may add costs to a transaction that are not always accounted for in pricing the deal. This is especially an issue in high transfer tax rate jurisdictions such as New York City and Philadelphia.

In addition, real estate transfer taxes may apply even when owned property is not being conveyed by deed. Some jurisdictions tax a

transfer of a controlling interest in real estate (often defined as 50 percent or more of the interests in the property owner). If transfer taxes are triggered by a transaction, the obligation for payment can be negotiated between buyers and sellers.

5. Real Estate as Collateral/Title and Survey

To the extent that financing is being used in connection with the acquisition (or even with an all-cash closing, if one contemplates eventual financing), the lender will often seek additional liens on real property assets (as well as inventory), particularly when there might be heavy equipment that constitutes fixtures. Part of thorough diligence will include review of existing title insurance policies (or other title work) and surveys of the target's properties. Again, review of the state of title and survey, in addition to yielding information for the acquirer, may highlight items such as violations, possible zoning issues, easements or restrictions affecting the use of the property.

Where a lender desires to take a lien on assets or inventory at a leased location, it may require landlord waivers of lien. If that can be anticipated, the acquirer may consider insisting in the transaction documents that the waivers be a closing condition, or at least that the target cooperates in seeking these waivers from its landlord.

In addition, title reports (and ultimately title policies, if required), surveys (if unavailable or stale) and zoning analyses or reports (if needed based on the type of property or transaction) can be fairly significant lead-time items and may add unanticipated costs to a transaction. Also significantly, whether the acquirer or target is obligated to pay for title reports, policies, updated surveys and the like, is often not discussed at the deal stage of a transaction, which may lead to disputes as these costs add up.

In sum, inattention to the real estate issues, although normally unlikely to torpedo a transaction, can lead to unexpected expenses and headaches, both prior to closing and beyond.

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The Top Five (Avoidable) Antitrust Traps in M&A Transactions

In M&A transactions, the parties are often focused on negotiating the transfer of assets or equity, and may treat antitrust as a mere procedural milestone. Parties may neglect potential antitrust concerns until after the agreement is negotiated. By that point, however, important negotiating and strategic planning opportunities may have been lost, and substantive antitrust defense of a deal may be compromised by imprudent document creation or other missteps along the way. Neglecting antitrust considerations until late in the transaction planning process may lead to unnecessary expense and delay. Five avoidable antitrust pitfalls to keep in mind when planning a transaction are discussed below.

1. Developing an Antitrust Strategy

Potential antitrust issues will inform the parties' strategy in connection with several threshold negotiation issues including due diligence, deal timing and contract negotiations. As a consequence, it is essential to scope out whether the proposed transaction raises potential antitrust concerns at the earliest stages of the transaction planning process. Some preliminary questions to ask include:

- Do the parties compete with one another?
- Do either or both of the companies have significant market shares in these overlap areas?
- Will the transaction result in the consolidation of the market to only a few competitors?
- Do the parties believe that customers will have competitive concerns about the proposed combination?
- Does one party supply the other, and if so, is the buyer acquiring a key input that might foreclose its competitors from access to a step in the supply chain?

Besides discussions with business personnel, strategic plans prepared in the ordinary course of business may provide an unfiltered view of the competitive landscape and whether the business considers the other party as a competitor and to what extent.

Recognizing up front whether a transaction may raise antitrust issues and forming an antitrust strategy to address those issues can impact how the parties engage with one another throughout deal negotiations and pre-closing integration planning, as discussed further below. An antitrust strategy can also facilitate the parties'

ability to manage the regulatory review process more effectively by proactively addressing the anticipated concerns of their customers and, ultimately, the antitrust agencies. Being proactive in approaching antitrust concerns allows parties to budget their time and money accordingly and avoid surprises along the way.

2. Document Control

Careless document creation can make an easy deal hard by raising questions where there otherwise would not be any. Conversely, careful wording can make a hard deal easier to defend. Whether or not the parties anticipate significant antitrust issues, careful document creation is a best business practice that can mitigate against undue costs and delays in the course of an antitrust review.

Documents prepared by the parties and their advisors that evaluate the deal are the most important information in the regulators' initial review, and can make or break the antitrust review of a deal. When creating transaction-related documents, parties should be careful to avoid antitrust "buzz words," such as: market leader; dominant position; high entry barriers; rationalize pricing or competition; achieve pricing power; avoid a price war; foreclose competition; or increase costs for rivals. This obviously applies to all press releases, talking points, frequently asked questions and Securities and Exchange Commission (SEC) filings, but also to all internal presentations, documents and communications – including "private" e-mail correspondence.

The recently revised joint Horizontal Merger Guidelines by the Department of Justice (DOJ) and Federal Trade Commission (FTC) emphasize the evidentiary importance of parties' ordinary course documents, such as business and strategic plans. Consequently, regardless of whether a company is currently contemplating a transaction, it should exercise care in how it discusses and documents competition and pricing decisions in internal documents because these documents will carry greater probative weight in an antitrust review than the deal-related documents prepared with the antitrust agencies as the anticipated audience. Further, in the event the deal evaluation documents were not carefully created, ordinary-course documents that contradict the puffery in the deal-related documents will be helpful in defending the merits of the transaction.

3. Informed Contract Negotiation

Understanding the potential antitrust regulatory obligations and concerns that a transaction may raise allow the parties to enter into better informed deal negotiations. From a procedural standpoint, parties need to consider their merger notification obligations for purposes of determining various conditions to closing. Considering both procedural and substantive issues, parties need to ensure that they build in enough time to allow for resolution of any anticipated merger reviews and negotiate how closely they will cooperate with one another to complete those reviews. With respect to substantive antitrust concerns, the parties need to consider how much antitrust risk they are willing to accept. For example, the seller may feel strongly about a "hell or high water" clause or a break-up fee, whereas the buyer may not be willing to accept so much antitrust risk. The parties cannot make informed decisions about termination provisions or other contingency planning without first exploring the relevant antitrust issues.

4. Merger Notification Assessment

While parties need to analyze whether they are subject to merger notification regulations in various jurisdictions around the world, applying the U.S. merger notification regulations under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act) can be complicated and yield unexpected results. Generally, acquisitions of voting securities, assets or a controlling interest in a non-corporate entity (such as an LLC or partnership) valued above $263.8 million (adjusted annually for the change in gross national product), or above $66.0 million, but below $263.8 million if the parties also meet certain net sales/total assets thresholds, are reportable where no exemptions apply.

The size-of-transaction is measured according to what a party will hold "as a result of" (that is, following) the transaction. Thus, for example, acquiring one more share of stock (whether on the open market or through some other channel) where a shareholder already holds stock of an issuer, and the aggregate value of the stock to be held as a result of the transaction is in excess of the reporting thresholds may require an HSR notification. Other examples of reportable transaction that might not be intuitive include: conversion of non-voting stock, options or warrants; transactions where the seller receives stock as consideration; and secondary acquisitions, *i.e.*, the indirect acquisition of minority interests held by a target.

Parties need to be sensitive to these types of situations, and plan ahead to avoid a situation where they have unwittingly acquired equity interests or assets without first observing the waiting period under the HSR Act, which can result in civil penalties of up to $16,000 per day.

Finally, parties need to be sensitive to a growing number of foreign filing requirements whenever a transaction has an international component. Notification thresholds are surprisingly low in many jurisdictions, and substantial lead time is required for the preparation of non-U.S. notifications. Disparate waiting

periods across jurisdictions will effect transaction timing. As a consequence, parties should undertake a review of potential obligations early in the transaction planning process to avoid delays and added expense.

5. Avoiding Gun Jumping

So-called "gun-jumping" can occur in two contexts. First, there is procedural gun-jumping, whereby one party takes beneficial ownership of voting securities, assets or non-corporate interests without first observing the statutory waiting period under the HSR Act. Such activity may result in civil penalties of up to $16,000 per day that the parties are not in compliance with the HSR Act. This prohibition applies regardless of whether or not the parties compete with one another. Parties can avoid this risk by continuing to operate as separate independent entities and not consummating the transaction prior to the expiration or termination of the HSR waiting period.

Second, there is substantive gun-jumping, whereby *competitors* that are planning a transaction begin to act in concert prior to the closing of the transaction, giving rise to claims of unlawful collusion under Section 1 of the Sherman Act. The DOJ and FTC understand that the parties need to exchange certain information through due diligence and integration planning, and need to preserve the value of what the buyer has agreed to acquire through restrictive covenants on the seller prior to closing. However, the agencies become suspicious when the information exchanged is competitively sensitive or not appropriately quarantined, or the buyer's restrictions on the seller's independent operation prior to close goes beyond trying to merely preserve the value of the business.

To reduce the risk of gun-jumping, parties should avoid the following:

- Do not exchange competitively sensitive information without prior consultation with antitrust counsel.
- If the exchange of competitively sensitive information is necessary to evaluate whether to proceed with the transaction, or to close the transaction,
  - Consider implementing "clean teams" to handle the information, and keep it from personnel who could act on it in the course of their day-to-day job functions,
  - Consider outsourcing pre-closing integration planning functions,
  - Use historical or aggregated information, and
  - Limit the data to that which is relevant and necessary to the process of negotiating and consummating the transaction.
- Do not include covenants in the transaction agreement that effectively allow the buyer to take beneficial ownership or exercise pre-closing control of the target.
- The parties may undertake integration planning prior to closing, but should not implement those plans until after closing. Parties should undertake these activities pursuant to integration planning guidelines developed in consultation with antitrust counsel.

Conclusion

Parties should be sensitive to antitrust issues – both procedural and substantive – at the earliest stages of the planning process in any proposed transaction. These issues will impact due diligence, contract negotiations, deal timing and integration planning. Prudence and careful planning will avoid surprises—and resulting expense and delay. Moreover, failure to involve antitrust counsel early on in the process may jeopardize the parties' ability to obtain antitrust clearance for their deal and, worst case, it may give rise to additional antitrust risks separate and apart from the underlying transaction itself.

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The Top Five Traps in Health Care M&A Transactions

In addition to the typical pitfalls and traps of corporate deals, health care M&A transactions also give rise to additional risks related to compliance with the specific laws and regulations that govern this complex industry. Health care businesses in the United States function within an intricate regulatory scheme, the requirements of which are brought to the fore when contemplating a transaction. The role of these issues is of increasing importance as the United States experiences a notable increase in health care provider M&A activity, which some have attributed to the passage of health care reform legislation and related alignment initiatives. Failure to fully comprehend the scope of these matters in health care M&A transactions is a recipe for potential deal disaster.

The following represent but five of the many traps counsel and business leaders may encounter in health care transactions.

1. Importance of In-Depth Due Diligence and Increased Regulatory Scrutiny

Perhaps no industry in the United States is as highly regulated as health care, thereby providing ample opportunity for risk. As a result, M&A transactions in the health care sector call for a level of diligence that exceeds that of corporate transactions in other business areas. Noncompliance with health care laws is a big dollar risk for health care businesses: the government can, by law, impose significant penalties and operational restrictions on noncompliant entities. In addition to the general function of permitting acquirors to identify material financial risks that may affect price, due diligence in health care M&A transactions provides an opportunity for acquirors to assess regulatory compliance risks. As such, use of a "standard" corporate due diligence request list is not sufficient in health care M&A transactions, as these forms typically do not contemplate the spectrum of documents and information relevant in health care due diligence.

Enforcement of health care laws is anticipated to increase moving forward, both as part of the Patient Protection and Affordable Care Act of 2010 – better known as the "health care reform legislation" – and as part of general government efforts to crack down on fraud and abuse in the health care arena. Both sellers and buyers in this context are advised to carefully prepare for and approach due diligence in any health care M&A transaction – sellers from the perspective of anticipatory preparation and buyers from the perspective of determining both a "go/no-go" with the deal and thoroughly evaluating risks to be abrogated or compensated as part of the transaction.

Enforcement activity in health care has been on the rise in recent years, with the government taking an active role in enforcing the complex laws applicable to health care providers and suppliers, including the Anti-Kickback Statute and Physician Self-Referral Law (referred to collectively herein as the "Fraud and Abuse Laws"). The Fraud and Abuse Laws make illegal certain business, referral and financial arrangements that are ordinary course in other business sectors. Complicating matters, the activities that constitute violations of the Fraud and Abuse Laws may be subtle and difficult to discern. As certain of the laws are strict liability statutes, even the smallest infraction without intent is on par with a flagrant violation, weighing the ability and basis for enforcement in the government's favor. Violation of the Fraud and Abuse Laws can result in the imposition of severe penalties, including fines and civil monetary penalties (or costly negotiated settlements in lieu thereof) and restrictions or prohibitions on participation in federal health care programs.

Accordingly, due diligence of health care businesses and operations must necessarily include a thorough review of compliance with health care laws, including the Fraud and Abuse Laws, to assist in identification of noncompliance and give the parties an opportunity to address any issues. So-called "defensive diligence" by potential sellers in advance of undertaking a bid process or otherwise entering the M&A marketplace is becoming more common, and health care regulatory counsel increasingly recommend that potential sellers undertake such proactive reviews before permitting a potential acquirer or partner access to information.

In the M&A context, addressing noncompliance with health care laws has increasingly taken the form of self-disclosure to the government in anticipation of undertaking an M&A transaction after internal "defensive diligence" or hand-in-hand with a potential acquiror or partner either during the negotiation of or prior to closing of a transaction. Other disclosures may occur under the real or perceived threat of disclosure from a *qui tam* relator (whistleblower) who has knowledge of the noncompliance.

In addition, health care M&A due diligence must involve areas of risk unheard of in other industries, such as Health Insurance Portability and Accountability Act (HIPAA) (health information privacy) compliance and research program compliance, to fully evaluate these sources of additional potential risk.

2. Complexity of Governmental Regulation, Licensing and Accreditation Matters

Health care businesses are highly regulated and typically require numerous local, state and federal licenses, permits, accreditations and approvals in order to operate. Licenses, permits and accreditations are often nontransferable, or require significant paperwork and lead time in order to complete transfers within the deal timeline. Ensuring that health care providers and suppliers who participate as providers in federal and state health care programs are appropriately enrolled in these programs is vital to smooth transition of operations post-closing. As health care businesses require licensure and sometimes accreditation to treat patients – and bill for patient care, particularly through the federal health care programs that are the lifeblood of most hospitals and other health care facilities – the threat to interruption of operations, revenue and reimbursement if these matters are not carefully handled as part of an M&A transaction cannot be understated.

In addition, many states restrict the employment of licensed professionals – most commonly physicians, and sometimes others – by corporations, which corporations are thereby viewed as undertaking the practice of that profession in contravention to state law requiring licensure for such activities. These "corporate practice" issues arise frequently in health care M&A transactions where a post-closing corporate structure or the merger or other reorganization of the corporate structure contemplates a corporation's employment of licensed providers.

3. Increasing Antitrust Scrutiny

Health care transactions with competitive implications are subject to increased scrutiny by the Federal Trade Commission (FTC) and Department of Justice (DOJ). Health care M&A transactions that meet certain thresholds require filings with and clearance from these agencies before the transactions can be consummated.

The FTC has recently linked its enforcement efforts to the desire, as expressed in health care reform legislation, to improve quality and control health care costs through careful management of the market. Merger enforcement has also been identified as a top priority of the Obama administration. Where a proposed transaction may adversely impact competition, the FTC and DOJ analyze the efficiencies identified by parties and consider whether the efficiencies outweigh the transaction's potential anticompetitive effect (to avoid presumed harm to patients, *i.e.*, through price increases). A comprehensive review and analysis of the potential efficiencies of a proposed health care M&A transaction is an absolute must in the early stages of transaction planning for those deals that have competitive implications.

Accordingly, an up-to-date understanding of relevant antitrust guidelines and their potential impact on a deal is essential to appropriately structuring health care M&A transactions.

4. Special Considerations for Nonprofit Health Care

A significant amount of hospital and health care operations in the United States is owned and operated by nonprofit corporations. Knowing the client's business and anticipating traps in this context includes an understanding of the role of mission, vision and values inherent in such operations and an appreciation of the many differences between nonprofit and for-profit health care deals. For example, the true "bottom line" for nonprofits is often tempered by mission more than profit.

In order to maintain their tax-exempt status, nonprofit health care business entities must comply with the regulations and requirements of the Internal Revenue Service. These requirements impact many aspects of M&A transactions, including, by way of example, the need for nonprofits to obtain valuations to substantiate that, as a buyer, it pays fair market value in acquisitions from for-profit entities, or the need to use proceeds only for exempt activities. In addition, nonprofit health care assets are viewed as "charitable assets" of the relevant state in which they are located, and in many states the sale or other disposition of charitable assets to a for-profit enterprise is subject to the approval of the state Attorney General. More and more, states Attorney Generals are intervening in nonprofit health care M&A transactions, particularly those transactions where a nonprofit entity sells some or all of its businesses to a for-profit enterprise. Even where state law does not provide a specific right of intervention, an Attorney General may invoke his role as protector of charitable trusts generally as a basis for such scrutiny. Of additional concern, states which have historically recognized nonprofit health care facilities as exempt from property taxes have started to scrutinize and in some cases revoke that status upon a change of ownership or control of the property – even if the change results in continued nonprofit ownership.

5. Additional Concerns for Catholic Health Care

A significant segment of nonprofit health care operations in the United States is affiliated with the Catholic Church. According to the Catholic Health Association, there are more than 600 Catholic hospitals and 1,400 long term care and other health care facilities operating in the United States. Health care entities affiliated with the Catholic Church must obtain the approval of the Holy See – the "headquarters" of the Catholic Church in Rome – before entering into certain transactions. This approval, called an "Indult," is issued after the party selling or otherwise transferring property prepares an intricate application to the Holy

See, usually under the guidance of an expert in Canon (church) law. Approval of Indult requests can take weeks or even months to obtain, potentially impacting the timing of a deal if not thought out in advance.

In addition, Catholic health care sellers or buyers may require an acquiror to retain, or an acquired entity to follow, the *Ethical and Religious Directives for Catholic Health Care* (the "Directives"), specific guidance promulgated by the U.S. Council of Catholic Bishops applicable to business operations and patient care and treatment at Catholic health care facilities (*i.e.*, provision of spiritual care and prohibition of sterilization and abortion). In the M&A context, the Directives may have a business impact on facilities that are sold or acquired by Catholic entities, and sometimes result in community concern regarding a restriction of certain services being available in the community.

Conclusion

Counsel to health care businesses and health care business leaders must be prepared for potential transaction traps to avoid significant liability and transaction risks. Involvement of counsel experienced in health care M&A early in deal planning and throughout the life cycle of the transaction is key to successfully navigating these issues.

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The Top Five Traps in Energy M&A Transactions

Energy M&A transactions require counsel with specialized knowledge of the energy business, project or portfolio of projects being acquired or sold. Such knowledge requires deep understanding of the energy industry across many legal disciplines, including general corporate, tax, energy regulatory, environmental, health and safety, employee benefits, real estate and often international. Without this understanding, parties to energy M&A transactions may find themselves hindered by the following common problems.

1. Lack of a Broad Knowledge Base

The energy industry is highly complex, with varying market structures and regulations throughout the world. As a result of this complexity—particularly the energy, environmental, health and safety, and other regulations affecting the industry—energy M&A transactions are rife with risk that is difficult to identify, navigate and understand. Failure to adequately identify and understand the level of risk involved in a transaction may result in dire consequences, including overvaluation of the business or assets being acquired, limitations on the intended use of the assets after closing, fines, penalties and other unforeseen liabilities.

While some issues may be common to the energy industry or a specific segment thereof, issues and risks more often than not vary across the industry, or even a segment of the industry, based on location and the type of business or asset. For example, the power generation business is subject to completely different regulations and market structures depending on the state and region where a power plant is located. Some parts of the United States have regulated markets, and others have deregulated markets. The nature of these markets may differ substantially depending on the structure, rules and regulations established by the relevant Independent System Operator or Regional Transmission Organization, the applicable state's public utility commission (PUC) and the Federal Energy Regulatory Commission (FERC). Further, natural gas fired, coal fired, wind, solar and biomass power projects each have their own unusual issues, risks and concerns. The power generation business is but one example. The energy industry as a whole is exceptionally complex, and each business, asset and jurisdiction—regardless of the energy industry segment—will often have unique regulations, rules and market structures.

The energy industry is further complicated by the commercial arrangements in which energy businesses are involved. The large capital outlays involved in these transactions warrant a detailed due diligence review that complements the business team's evaluation of the business being purchased, including complex project finance documents; performance and efficiency guarantees (*e.g.*, heat rates, availability guarantees and other performance metrics); tying input and output risks; hazardous substance arrangements; gathering, processing and refinement of hydrocarbons; transportation agreements; and interconnection and transmission rights and agreements. To ensure a successful M&A transaction, the person performing this review should have the knowledge necessary to identify the pertinent information, issues and risks associated with these industry-specific complex commercial arrangements.

2. Misunderstanding Risks Involved with Project Based Assets

Many energy industry M&A transactions involve projects, portfolios of projects or development assets. The value of each individual project is driven by the cost of its operation, including fuel supply,

and the revenue generated by its assets. The due diligence process should evaluate each side of this equation in order to provide a clear picture of the legal, regulatory and economic health of the project. In addition, projects often have their own financing, interconnection rights, permits and real property rights, each of which may have a material impact on the operation or performance of the project. Finally, development assets present their own risks and vary depending upon the relevant assets' development stage. Special care should be given to identifying and analyzing the risk associated with the completion, construction, commissioning and operation of such assets.

Fuel supply, warranty agreements, operation and maintenance, and other material agreements affecting the cost of performance should be reviewed and evaluated to determine the legal, regulatory and commercial risk involved in such agreements, including potential increases in the cost of the performance of the project over time, anticipated deterioration in performance, and the adequacy of fuel supply, replacement parts and other inputs. This analysis should include the identification of material exposure or weakness in these commercial arrangements, including issues in availability guarantees, response times, fuel delivery, minimum commitments for parts or fuel, and other hidden costs.

A project's revenue contracts are crucial to the value being assigned to a project. Performance guarantees, credit support requirements and credit exposure, off-takers' rights to refuse performance, early termination rights and the allocation of risk between the parties for *force majeure*, curtailments and other uncontrollable risks must be indentified and understood in order for the business team to evaluate the project's revenue stream.

Project companies are often subject to other legal or commercial arrangements that affect their operation and performance, including project financings, transmission or transportation agreements, interconnection agreements, permits and real property rights. The covenants in these various agreements can influence the project company's ability to operate its assets and perform its obligations under its fuel supply and revenue contracts. Therefore, material issues within such arrangements should be identified and analyzed when assessing the overall value and risk associated with the project.

Finally, energy M&A transactions often involve the acquisition of development assets. In these situations, the purchaser often assumes the additional risk that the project will be capable of being completed. The due diligence process is critical in evaluating the level of development and other work that must be completed before the project can be constructed, commissioned and placed into service. This includes evaluating the risk of delay in obtaining permits and other governmental authorizations; completion of the project interconnection; and obtaining adequate transmission, transportation or other rights necessary to timely complete the project.

3. Difficulty Identifying Energy Regulatory Issues

The energy industry is highly regulated and requires numerous local, state and federal licenses, permits and approvals in order to operate. A business may be the subject of enforcement or other proceedings in front of FERC, a state PUC or another regulatory commission. Regulatory issues and material proceedings affecting a business or transaction should be identified in the due diligence process and adequately addressed and understood by the parties prior to entering into the purchase and sale agreement.

The regulatory knowledge required for an energy M&A transaction will depend on the business or assets being purchased and acquired, and the jurisdiction in which they are located. For example, M&A transactions involving interstate natural gas pipeline projects will require FERC experience that differs from the FERC experience required for M&A transactions involving power generation and transmission assets. Additionally, each state adds its own regulations through legislation, PUCs, railroad commissions or other authorities. Accordingly, the regulatory advice needed for a transaction will depend upon the nature of the business being purchased and sold, and the location of its assets.

Finally, regulatory approvals and notices may be required for certain types of M&A transactions. For example, Section 203 of the Federal Power Act requires FERC authorization for mergers, dispositions and acquisitions involving electric generation and transmission companies. Section 1289 of the Energy Policy Act amended section 203 of the Federal Power Act and expanded FERC's authorities and requirements. The right regulatory advice can be critical to navigating these and other approvals and authorizations.

4. Missing the Full Legal Picture

The laws and regulations affecting the energy industry go beyond the energy regulatory regime and include environmental, health and safety, tax, employee benefits and real property issues. Therefore, energy infrastructure M&A transactions often require the support of skilled professionals in environmental, health and safety, tax, employee benefits and real estate law in order to provide a complete picture of the risks to a business or project.

Coal, natural gas and nuclear power plants, as well as upstream, midstream and downstream oil and gas assets, all are faced with

their own unique environmental challenges, including emission permits, potential carbon and frac fluid regulation, and pre-existing conditions and liabilities associated with releases of mercury, petroleum, radiation and other potentially environmentally hazardous substances. Even renewable energy projects face stringent environmental regulations related to preserving wetlands and mitigating the impact a project may have on animal and plant life. Equally important is the identification and analysis of issues relating to the health and safety of workers; the tax structure of the transaction; depreciation rights; and, in the context of renewable or nuclear energy projects, qualification for tax credits and treasury grant programs, ERISA, employee benefit liabilities and real property rights. Accordingly, knowledge covering a wide range of the law is necessary for a complete picture of the risks and liabilities involved in an energy M&A transaction.

5. Inadequate Identification of International Exposure

Oil and natural gas are global commodities, and energy companies frequently do business around the world. Accordingly, energy M&A transactions often involve projects, assets or businesses located in foreign jurisdictions. The rules and regulations affecting the energy business vary widely around the globe, and local professionals should be engaged to assist with M&A transactions involving foreign operations in order to properly understand these differences. Similarly, international transactions may involve additional U.S. legal issues that should not be overlooked, such as compliance with the Foreign Corrupt Practices Act.

Conclusion

The market structure, regulations and commercial arrangements associated with the energy industry are complex and varied. The right skill and understanding of the business involved is crucial to successfully identifying, navigating and addressing the risks associated with energy M&A transactions.

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The Top Five Traps in Distressed M&A Transactions

"The Chinese use two brush strokes to write the word 'crisis.' One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger—but recognize the opportunity." John F. Kennedy, speech in Indianapolis, Indiana, April 12, 1959.

As a result of the contraction of the capital markets, it has become increasingly difficult for distressed corporate borrowers to refinance their existing debt facilities, recapitalize their businesses or even obtain the debtor-in-possession financing necessary to reorganize through bankruptcy. As a result, distressed sales—both inside and outside of bankruptcy—have become commonplace. Most distressed M&A transactions are structured as asset sales, rather than corporate mergers. By purchasing the assets of a distressed business, the purchaser is able to extricate and unburden the operating assets from the debts and liabilities of the distressed seller. The exigent circumstances surrounding distressed sales, the often-precarious relationship between the seller and its lenders, and the lack of meaningful strategic alternatives available to the seller place downward pressure on the purchase price and create the opportunity for value.

Commensurate with the opportunity for greater value, distressed M&A transactions also present greater risk, particularly execution risk. In many instances, the purchaser is dealing not with a willing seller, but with a coerced seller that is being forced to liquidate by its senior lenders. The purchaser may find the seller's principals to be recalcitrant, making it more difficult to get the deal done. Moreover, the distressed seller's creditors (most particularly, junior lien holders) may attempt to interfere with or scuttle the sale in order to gain leverage in their negotiations with senior lenders. Each of these risks can, of course, be managed, but any purchaser evaluating a distressed acquisition should be mindful of the following five traps.

1. Selecting the Right Process for the Acquisition

One of the most important decisions that a purchaser must make in connection with a distressed M&A transaction is how to implement the sale. Because every transaction is unique, a purchaser should give careful thought to the proper procedural approach. The decision may be driven by a myriad of factors, including (i) the nature and complexity of the business and its assets, (ii) the seller's need for and access to operating capital in the interim period prior to a closing, (iii) the extent and priority of the existing liens, (iv) the level of acrimony among creditor constituencies and (v) the time available to complete the transaction. Choosing the

wrong approach may jeopardize or complicate the execution of the transaction.

Potential implementation options include (i) a bankruptcy sale pursuant to Section 363 of the U.S. Bankruptcy Code, (ii) a secured creditor disposition pursuant to Article 9 of the Uniform Commercial Code (UCC), and (iii) a receivership or assignment for the benefit of creditors (ABC). Each option has relative benefits and detriments. Although it is beyond the scope of this article to address the intricacies of each approach in detail, a broad overview the three basic approaches is helpful.

- **Bankruptcy Sale.** Bankruptcy sales provide a number of benefits that cannot be obtained outside of bankruptcy. The most significant benefit is that the assets are generally transferred to the purchaser free of all claims, liens and encumbrances, pursuant to Bankruptcy Code Section 363(f). The purchaser is given clean title and the benefit of a federal court order insulating the purchaser from successor liabilities and other claims and liens previously associated with the assets. In addition, the court is generally authorized under Section 365 of the Bankruptcy Code to effect an assignment of the debtor's executory contracts and unexpired leases to the purchaser even if they contain provisions purporting to prohibit assignment. However, compared to the alternative approaches discussed below, a bankruptcy sale can be tremendously expensive, somewhat unwieldy and relatively slow to implement.
- **UCC Article 9 Disposition.** A distressed asset sale can also be implemented through a secured creditor disposition under Article 9 of the UCC. The UCC authorizes a secured creditor to dispose of personal property by public or private sale. This is a non-judicial method of foreclosure and generally has the effect of discharging any junior liens and security interests on the assets, but it does not provide the breadth of protection conferred by a bankruptcy court "free and clear" order. An Article 9 disposition can be implemented relatively quickly (in a matter of weeks) and is cost effective in comparison to a Section 363 sale in bankruptcy. However, in some instances, going concern value may diminish during the foreclosure process based upon the reaction of the seller's employees, vendors and customers.
- **Receivership or Assignment for Benefit of Creditors.** A receivership generally involves a judicial proceeding whereby the receiver is placed in control of the seller and its assets. An ABC is a non-judicial proceeding whereby the debtor assigns all legal and equitable title to its assets to a trust for the benefit of its creditors. The "assignee" (or trustee) is empowered to administer the trust estate for the benefit of the debtor's creditors. In each case, the receiver or assignee collects and liquidates the assets of the estate and distributes the proceeds to the appropriate creditors in accordance with their priorities. Generally speaking, neither a receivership sale nor an assignment discharges liens or security interests, but they can be used to sell assets under circumstances where a secured creditor consents to such sale, and the sale must be accomplished in a relatively short time period.

2. Multi-Party Negotiations

Unlike a "healthy" M&A transaction, a distressed asset sale is not a transaction between the seller and the purchaser alone. This is especially true of a sale in bankruptcy. A purchaser in a distressed sale is often required to negotiate with and/or placate multiple constituencies, including (i) senior and junior lien holders, (ii) trade creditors, (iii) an unsecured creditors' committee, and (iv) a bankruptcy judge. Each of the seller's various creditor constituencies may have its own agenda, which may or may not be consistent with the purchaser's objectives in the transaction. Dealing with intransigent creditors requires both flexibility and resiliency on the part of the purchaser.

3. Rights of Senior Lien Holders; Credit Bidding

Of all the creditor constituents involved in or affected by a distressed sale, the most important from the standpoint of the purchaser is the seller's senior lien holders. It is critical that the purchaser reach an agreement with the senior lenders regarding the sale terms, and involve them in the process. Absent the consent and support of the senior lenders, the transaction is unlikely to succeed. In many instances, the seller cannot continue to operate pending a sale without the interim financing provided by the senior lenders. Furthermore, with respect to an Article 9 disposition, it is the senior lien holders who initiate the process. Even in the context of a bankruptcy sale, the Bankruptcy Code recognizes the right of a secured creditor to "credit bid" its debt at the auction.

4. Stalking Horse Protections

In most instances, distressed sales—both inside and outside of bankruptcy—are market tested and subject to higher and better bids. Accordingly, it is tremendously advantageous for a purchaser to act quickly at the outset and negotiate to become the stalking horse. Serving as the stalking horse gives a purchaser the inside track. The purchaser will generally be able to shape the auction procedures governing the sale. Those procedures not only protect the stalking horse's interests in the event it loses the transaction to another bidder (by providing a break-up fee and/or expense reimbursement, for example), the procedures can also provide the stalking horse with a strategic advantage.

5. Limited Due Diligence; Fewer Contractual Protections

In contrast to a "healthy" M&A transaction, a purchaser in a distressed sale is often given very little time to conduct due diligence and has substantially fewer contractual protections. Due diligence must be executed efficiently and expediently, focusing primarily on the mission critical aspects of the transaction. Also, under the typical distressed asset purchase agreement, the purchaser is not given meaningful rights of indemnification. The representations and warranties made by the seller are fewer and more narrowly tailored than in a healthy M&A transaction. Moreover, there is often no hold-back or escrow provided to the purchaser to protect against a subsequently revealed breach. In some cases, distressed asset sales are conducted on an express "as is, where is" basis with no representations at all.

For all of these reasons, it is incumbent upon the purchaser to factor the additional transaction risk into the purchase price offered to the seller, thereby striking the proper balance between "danger" and "opportunity."

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The Top Five Traps in M&A Transactions in China

As the second largest economy in the world, China has become one of the top global markets for M&A transactions. However, like many emerging markets, the Chinese legal, regulatory and business environment is still in a state of flux, and unwary foreign investors often fall prey to various traps in M&A transactions in China. In order to pursue and close a successful M&A deal in China, an investor must possess a thorough understanding of the local risks and challenges of Chinese characteristics, and wisdom and courage to come up with well-thought-out and creative solutions.

1. Regulatory Maze

Along with its rapid economic development, China in recent years has quickly established multiple complicated layers of regulation on M&A activities, which mainly include industry access review, antitrust review, national security review, tax and foreign exchange regulation, and supervision of the sale of state-owned assets.

An M&A transaction may be subject to the examination and approval of several different agencies and regulatory regimes, depending on the specific conditions of the target business to be acquired, *e.g.*, the industry sector and transaction type; whether the target business is encouraged, permitted or restricted for foreign investment; and whether the target business is state-owned, privately owned by foreign or Chinese entities, publicly traded or otherwise. If the target business is in key agricultural, infrastructure, defense, energy and resources, equipment manufacturing, technology or transportation services sectors, the M&A deal will trigger national security review by the Chinese government. Moreover, in the event the proposed M&A deal reaches the statutory threshold for antitrust review, the foreign investor must seek clearance from the antitrust authority in China before the deal can be closed.

The principal government agencies responsible for reviewing and approving M&A deals include the Ministry of Commerce (MOFCOM); the State Administrations of Industry and Commerce (SAIC), of Foreign Exchange (SAFE) and of Taxation (SAT); the State-Owned Assets Supervision and Administration Commission (SASAC); and the China Securities Regulatory Commission (CSRC). It is never an easy task for a foreign investor to navigate through red tape for a variety of approvals, and to make things worse, foreign investors often have to face the ambiguity of the law and the contradictory views and practices of different government agencies, which result from a combination of fast-changing and unclear laws and regulations and a lack of unified and detailed implementation rules.

Even though some M&A deals may be structured in such a way that the target business may be acquired outside China to minimize or avoid Chinese regulatory involvement, for most M&A deals, foreign investors and their counsel should be fully aware of the challenges in obtaining various regulatory approvals from the Chinese government, and should do sufficient homework to prepare and implement a sensible action plan.

2. Hidden Liabilities

Hidden or contingent liabilities associated with previous operations of the acquired business are a key area of concern in most M&A transactions. Such legacy liabilities may arise from a wide variety of sources in China, including but not limited to unpaid tax, insufficient social welfare payments, undocumented guarantees, non-compliant transfer pricing arrangements, product liabilities, customs violations, environmental liabilities and other regulatory violations.

To identify such legacy liabilities and protect the acquired business from them, foreign investors must conduct due diligence on the operational and financial conditions of the target business. As the publicly available information and government records about the

target businesses in China are often either inadequate or unreliable, the foreign investors will have to conduct their due diligence mainly based on the information disclosed by the target business.

Unfortunately, as in many emerging markets, foreign investors are often dismayed by the lack of developed accounting standards and the low compliance levels in accounting and disclosure obligations in China. For example, it is not uncommon for a family-controlled or owner-managed business in China to utilize various means to reduce tax that may contravene tax regulations, or to overstate the revenues for a better sale price, which may constitute commercial fraud. The recent scandals of Chinese companies listed in New York, Hong Kong and Toronto are just the tip of the iceberg of such risks.

There is no single magic procedure guaranteeing that all hidden liabilities and potential exposures will be identified. Savvy foreign investors should select experienced advisors (including a private investigator if necessary) who have the local knowledge and skill to identify the hidden issues at an early stage.

3. The Real Control of the Acquired Business

Foreign investors who acquire all or a majority of the equity interest in a target company often assume that they will have real control of the acquired business, but the painful fact is that control by equity is never guaranteed in China.

According to Chinese company law, every Chinese company will have a legal representative, who will be the chairman of the board of directors or the general manager of the company. While the legal representative may sometimes be held liable for various administrative and criminal liabilities of a company, the legal representative is also granted by Chinese law to have automatic power to act for the company. In other words, any important legal documents or court proceedings of a company must be signed by a legal representative, and more importantly, any contracts once signed by the legal representative will become binding on the company unless the other side knew or should have known such signature exceeded the power granted to the legal representative by the company. As foreign investors are often reluctant to take the position of legal representative for fear of the possible personal liabilities, the above statutory powers will often be given to the representative of the local Chinese partner or the original local Chinese management staff.

Additionally, every Chinese company will have a set of corporate seals, including a general seal, a financial seal and a contract seal. Like the signature of the legal representative, a stamp of these seals, particularly the general seal, will also make a legal document automatically binding on the company. As these seals are generally kept by local senior management to facilitate the daily operational activities of the company, the offshore shareholders may be kept in the dark when the company runs into trouble because of improper use of such seals.

4. Dealing with State-Owned Companies

Acquiring a state-owned business in China is subject to a more complex regulatory regime. To prevent the loss of state-owned assets, Chinese law mandates that any sale of state-owned assets shall be valued by authorized appraisers, and the sale of such assets can only be concluded following the public announcement, listing and opening bidding process in the Chinese assets exchanges. If the proposed M&A deal consists of a management buyout restructuring, a stricter procedure for the approval and public bidding will apply. Any deviation or violation of these procedures may entitle the state-owned assets supervision authority to challenge the validity of such transaction by legal proceedings, which, in the worst scenario, may even lead to criminal proceedings.

Because the most commonly used asset valuation methods for state-owned assets often produce inflated valuations, resulting in such statutory valuations not reflecting the true economic value of the business, the foreign investor would still need to perform its own valuation of the business to establish the price range which it is willing to pay for the target business. If there exists a significant discrepancy between the foreign investor's valuation and the above statutory valuation, it may be difficult to close the deal within the mutually acceptable price range, as the official appraiser's valuation will serve as the bottom price for such transaction during the public announcement and bidding process.

It is often difficult to understand the true quality of earnings of state-owned enterprises, as they generally have extensive direct or indirect interests in other business entities with whom they transact. Such related party transactions are often conducted on non-arms-length terms, and there can be significant alterations to the financial conditions of the target business once these related party transactions are either excluded or restated per fair market value.

Foreign investors should also be particularly aware of employment issues related to target state-owned businesses with significant labor redundancy. Because major layoffs might trigger worker protests and other social unrest, the whole transaction may be jeopardized if such labor issues cannot be properly settled. It should also be pointed out that given the various protections granted by Chinese labor laws to the employees, it will generally be very costly for foreign investors to settle such labor matters on their own.

5. The Legality of VIE Structure

Foreign investors often use variable interest entities (VIEs) to gain access to sectors of China's economy (such as telecommunications and media) that restrict or even prohibit foreign investment. VIEs have been widely used in the corporate structures of many "Chinese" ventures, particularly those in the telecommunications and media sectors, including internet services, online games, value-added services, radio, film and publications. Typically, these VIEs are owned by Chinese citizens and hold licenses, intellectual property, assets and so on, and they are controlled via contractual arrangements by a wholly owned foreign subsidiary (WOFE) in China owned by the foreign investor.

Although the Chinese government has not officially raised any objections to many companies using VIE structures to operate restricted businesses in China when they list in Hong Kong or the United States, the true purpose of such VIE structures is no doubt to circumvent the mandatory restrictions under the Chinese foreign investment laws, which alone shall sufficiently render such structure and the underlying contracts invalid under the Chinese laws. In addition, certain Chinese government agencies have already issued regulatory circulars to prohibit using VIE structures to run certain businesses, such as online games, in China.

Another major inherent risk of the VIE structure is the transfer-pricing issue, as the profits of the VIEs need to be controlled and moved up to the WOFEs established by the offshore entities in the name of management service fee, equipment lease, IP license royalties, etc. As the Chinese tax authority is tightening up its scrutiny on transfer-pricing activities, the reasonableness of the prices of various controlling contracts under the VIE structure may become a target.

Conclusions

These are just a few of the potential pitfalls foreign investors may encounter in their M&A transactions in China. Savvy foreign investors should deal with such challenges in an informed, flexible and creative manner, as, according to a Chinese saying, the big challenges always co-exist with big opportunities.

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