corporate advisory

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Reduction in Hart-Scott-Rodino Antitrust Transaction Thresholds

Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "Act"), before certain mergers, tender offers or other acquisition transactions can close, both parties must file a "Notification and Report Form" with the Federal Trade Commission. This enables antitrust regulators to review the transaction and investigate and address potential antitrust violations. The Act was amended in 2000 to allow for the annual adjustment of the notification thresholds based on changes in the United States Gross National Product. Thus, effective February 22, 2010, due to a decrease in the gross national product, the notification thresholds under the Act were lowered for the first time ever.

In general, a filing under the Act is required in two situations. First, a filing is required if the transaction is valued at $253.7 million or more (previously $260.7 million). Second, a filing is required if (a) the transaction is valued at $63.4 million (previously $65.2 million) but less than $253.7 million and (b) one of the parties has annual net sales and/or total assets of $126.9 million or more (previously $130.3 million) and the other party has annual net sales and/or total assets of $12.7 million or more (previously $13 million).

The values associated with the filing fee tiers also changed accordingly. The filing fee is (a) $45,000 for transactions valued in excess of $63.4 million but less than $126.9 million, (b) $125,000 for transactions valued from $126.9 million but less than $634.4 million and (c) $280,000 for transactions valued in excess of $634.4 million.

The lowering of the thresholds under the Act has the potential to increase the number of transactions subject to the Act's reporting requirements, and noncompliance with these requirements may subject a company to a statutory penalty of up to $16,000 per day. Therefore, it is important to accurately analyze and understand how this reduction in the Act's thresholds impacts transactions scheduled to close in 2010 and on.

Proxy Contest: Listed Company Strategies for Clearing Proxy Materials

In a proxy contest, being the first to mail and solicit proxy cards from shareholders can prove to be a key to the outcome of the contest. A listed company should expect the Securities and Exchange Commission (SEC) to review its solicitation materials in a proxy contest. If the SEC has comments, all comments must be resolved to the satisfaction of the SEC examiner before the solicitation materials can be filed and mailed. This can cause significant delay, allowing an activist shareholder an advantage to mail its solicitation materials to shareholders before the listed company therefore, striking with its message first.

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Listed Company Strategies for Clearing Proxy Materials (continued from page 1)

The proxy rules are complex. There is no foolproof way to avoid at least some comments from the SEC examiner, but there are strategies that may help minimize potential comments.

First, make each of the disclosures required by the proxy rules, paying particular attention to any focus areas identified by the SEC staff during the prior year. Also, provide clear support for each of the disclosures (i.e., the "why," not just "how").

Second, avoid certain statements, such as: (a) predictions about future market values or company performance, (b) opinions not clearly supported by fact, and (c) challenges to a person's reputation, character or integrity. The SEC examiner is almost certain to comment on any disclosure that could be deemed to be misleading. If any of the foregoing types of statements are made, the listed company should carefully draft such disclosure and provide clear factual support.

Third, provide the appropriate EDGAR tags to the filings and identify the party that has prepared the proxy statement, proxy card and other solicitation materials in order to clearly distinguish it from the filings made by the activist shareholder.

It is also worth noting that the "best defense may be a good offense." A third party may submit a "poison pen" letter to the SEC examiner to assist in the examiner's review of the activist shareholder's proxy materials. A "poison pen" letter is typically a letter to the SEC that closely scrutinizes the proxy materials filed by an activist shareholder in an effort to identify technical violations or a false or misleading disclosure that may prompt a comment from the SEC examiner. The SEC examiner has full discretion to review an activist shareholder's proxy materials with or without reference to the "poison pen" letter, but the "poison pen" letter could help point out inaccuracies or deficiencies that would not be otherwise readily apparent to the examiner. If successful, the result could be a detailed SEC comment letter that could significantly delay an activist shareholder's timing for filing and mailing its definitive proxy materials, allowing the listed company to win the race to file and mail to its shareholders first.

Antidilution Equations

Antidilution provisions are common in venture financing transactions, so it is important to understand the nuances. Set forth below is a "cheat sheet" for the long narrative that often accompanies the presentation of antidilution rights for preferred stock and other equity instruments.

Weighted Average Antidilution

Weighted average antidilution protection gives a degree of protection to prior investors in the event of a subsequent down round. The higher price in the prior round and the lower price in the subsequent round are "averaged." There are two general categories of weighted average antidilution—"broad-based" and "narrow-based"—with variations in between.

Broad-based weighted average antidilution calculates the "average" on a fully diluted basis, meaning that all convertible securities, options and warrants are deemed outstanding stock for purposes of the calculation.

Narrow-based weighted average antidilution calculates the "average" using only outstanding common stock in the denominator.

As between the two, broad-based is more company favorable and narrow-based is more investor favorable. See the example below:

EXAMPLE

Existing conversion price	=	$5.00
Outstanding common before new issue	=	1,000
Fully diluted common before new issue	=	1,500
Outstanding preferred	=	300
Outstanding options	=	200
New issue common	=	500
New issue price (down round)	=	$3.50 per share or $1,750.00

Broad-Based Weighted Average:

New Conversion Price = existing conversion price x (fully diluted common before new issue + common issuable at existing conversion price for total new issue consideration)/fully diluted common after new issue

New Conversion Price = $5.00 x (1,500 + 350)/2,000 = $4.625

Narrow-Based Weighted Average:

New Conversion Price = existing conversion price x (outstanding common before new issue assuming only conversion of preferred + common issuable at existing conversion price for total new issue consideration)/outstanding common after new issue assuming only conversion of preferred

New Conversion Price = $5.00 x (1,300 +350)/1,800 = $4.58

Full-Ratchet Antidilution

Full-ratchet antidilution reduces the conversion price to the lowest price at which a share or shares are issued by the company in a subsequent round. This is the most investor favorable and least company favorable antidilution protection.

EXAMPLE		
Existing Conversion Price	=	$5.00
New Issue Price	=	$3.50
New Conversion Price	=	$3.50

Summary

The chart below sets forth the relative impact of the above three antidilution equations. In each, our prior round of 300 preferred shares, which were originally convertible at the original issue price into 300 common shares, are adjusted as follows:

	Adjusted Conversion Price	Common Shares on Conversion
Original (300 x $5.00)/$5.00	$5.00	300
Broad-Based Weighted Average (300 x $5.00)/$4.625	$4.625	324.32
Narrow-Based Weighted Average (300 x $5.00)/$4.58	$4.58	327.5
Full-Rachet (300 x $5.00)/$3.50	$3.50	428.57

Delaware: Attorney-Client Privilege in M&A Transactions

If you send an e-mail to your attorney and copy your investment banker, is the communication privileged? Can it be discovered by an adverse party?

In the context of an M&A transaction, most recently in *3Com Corporation v. Diamond II Holdings, Inc.*, the Delaware Court of Chancery confirmed that, under Delaware law, such communication is privileged and not discoverable by an adverse party.

If your in-house general counsel negotiates the merger transaction, are all of his or her communications privileged and not discoverable? Under Delaware law and as reinforced in the above case, not necessarily.

The facts underlying these issues were as follows:

3Com and an entity formed by Bain Capital Partners LLC for purposes of a proposed merger transaction, Newco, entered into a merger agreement. Because a Chinese entity was to acquire a minority stake in the business following consummation of the merger, a voluntary notice was submitted to the Committee on Foreign Investment in the United States. This Committee indicated that it intended to recommend against the merger upon the same being submitted for Presidential approval; given this fact, and the unlikelihood of receiving the required approval, the notice was revoked and the merger agreement subsequently terminated.

3Com filed an action to recover a $66 million termination fee under the terms of the merger agreement and moved for summary judgment. Newco objected to summary judgment, claiming facts in dispute and a need for discovery.

Both parties withheld certain documents and redacted portions of others in the discovery process. The case raised a number of issues, including the following claims by Newco:

(a) Newco challenged 3Com's withholding of certain communications between its attorneys that also involved 3Com's investment banker, Goldman Sachs.

(b) Newco also challenged 3Com's claim that communications of its in-house general counsel, who also served a significant business role in the negotiations, were privileged.

As to the first, this issue in part was a question of the governing law. Although most of the negotiations occurred in Massachusetts, the parties had elected to have Delaware law govern the merger agreement and provided that Delaware was to be the exclusive jurisdiction for disputes under the merger agreement. The court determined that Delaware law should apply. Delaware law, on the privilege issue, is notably broader than Massachusetts law. The Delaware precedent, applied by the court in this case, deems communications among a client, its attorneys and its investment bankers in an M&A transaction privileged and not discoverable. Therefore, the mere fact that the investment bankers were copied or included in the communications did not waive privilege.

As to the second challenge, the governing Delaware law provides that internal communications between a company's officers and directors and its general counsel may be privileged depending upon whether the communications are legal or business in nature. Communications, or portions thereof, in which the in-house general counsel provides legal advice, or advice so intertwined with legal issues that it is primarily legal in nature, are privileged. But given the general counsel's substantial business role in the proposed merger transaction, the court determined that in camera review (review by the court) was appropriate to determine the capacity in which the general counsel was acting at the time of each challenged, withheld or redacted communication. Only communications in which the general counsel was acting in his legal capacity were privileged. Non-legal business communications, albeit by the general counsel, are discoverable.

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An IP Primer

How many times have you heard it said that intellectual property is valuable to your company and must be protected? Likely many times. Yet, how many people-outside of intellectual property attorneys-have a comprehensive understanding of the types of intellectual property protections that exist and the differences between them? This article will provide a brief summary of the different types of intellectual property protection and the protection each offers.

Intellectual property is commonly divided into patents, trademarks, copyrights and trade secrets. Each represents a different type of company asset. Understanding the differences in protection for each type is the first step in making sure that your company recognizes and protects its intellectual property.

There are two types of patents: utility patents and design patents. Utility patents protect new and novel inventions or ideas for how to do something.

10b-5: Mere Dissemination of Offering Materials Not Enough for Liability

In March 2010, the First Circuit issued an en banc opinion regarding the SEC's interpretation of liability for "making" a false statement under Rule 10b-5(b), in *SEC v. Tambone*, WL 796996. In a 4-2 decision, the full bench determined that in order for a securities professional to be liable under Rule 10b-5(b), he or she must actually make the statement at issue, not merely use or disseminate a statement written by another person.

In *Tambone*, the SEC alleged, among other claims, that two senior executives of Columbia Funds Distributor, Inc. violated Rule 10b-5(b). Columbia Funds acted as the underwriter and distributor for a group of mutual funds. Columbia Management Advisors, Inc. wrote the relevant prospectus, as the fund's advisor and did not employ the defendants. The SEC alleged that certain customers were permitted to "market time" Columbia funds, despite the relevant prospectus stating that the fund does not permit such transactions. The SEC claimed that because the defendants disseminated the prospectus they "made" this false statement. The district court dismissed all of the claims against the defendants and held that the SEC did not allege that the defendants personally made untrue statements. The district court explained that the defendants' roles in disseminating the allegedly misleading prospectus was insufficient under Rule 10b-5(b).

On appeal, the SEC argued that the defendants were liable under Rule 10b-5(b) because they used the prospectus in the sale of securities and the defendants had a duty to investigate the truth and accuracy of the prospectus they disseminated. By using the prospectus, the First Circuit reversed the district court's decision and reasoned that the defendants impliedly represented that the statements in the prospectus were true; therefore, the defendants "made" false statements. The full court of the First Circuit granted en banc review on this Rule 10b-5 issue. In the end, the full court affirmed the district court's dismissal of this Rule 10b-5(b) claim.

Rule 10b-5(b) provides that it "shall be unlawful for any person, directly or indirectly,… [to] make any untrue statement of material fact." The rule does not define the word "make," and therefore the court looked at the word's ordinary dictionary meaning, which includes "compose," "create" or "cause to exist." Notably, the plain definition of the word does not include "use" or "disseminate," and therefore the court reasoned that the SEC's interpretation of the word "make" was inconsistent with its ordinary dictionary meanings.

The court also looked to the structure of Rule 10b-5(b), which explicitly uses the word "make," and contrasted it against other provisions of the Securities Act, like Section 10(b) itself and Section 17, which utilize broader words, like "use" or "employ." The court reasoned that, based on doctrines of statutory interpretation, the drafters of Rule 10b-5(b) specifically chose the word "make," and therefore the drafters intended that its interpretation be limited in scope.

Ultimately, the court held that the SEC's "expansive interpretation" of Rule 10b-5(b) is inconsistent with the text and structure of Rule 10b-5(b) and other relevant statutes. In pertinent part, the First Circuit determined that a securities professional does not "make" a statement within the Rule 10b-5(b)'s meaning by using "a statement created entirely by others" or directing the offering and sale of securities on behalf of an underwriter, thus making an implied statement that he believes that the key representations in the prospectus are truthful and complete.

Common subject matter for utility patents includes industrial processes (e.g., a chemical process) and products (e.g., a new drug). Design patents protect the novel, ornamental and nonfunctional aspects of a useful article. A design patent might cover the ornamental and nonfunctional aspects of jewelry, furniture or even a purse. Both utility patents and design patents are issued by the United States Patent and Trademark Office and assigned a number, after a registration and examination process.

Most trademarks are also registered with the United States Patent and Trademark Office after undergoing an application and examination process. However, a company can have rights in a trademark even if it is not registered. A trademark is used to indicate that a product or service comes from a particular source. Trademarks are commonly word marks used on or in connection with a product or service. However, in certain instances other indications of source such as color, a sound or even a particular product design or appearance can function as a trademark.

Copyright protection covers a particular expression of an idea. Copyrights are granted to the author or creator of an original work. The most common examples of copyrighted works include books, songs, movies, and software. While copyrights are registered with the U.S. government at the Copyright Office, unlike patents and trademarks, they do not undergo a formal examination process.

Trade secret protection is similar to patent protection in that both can be used to protect new and novel inventions or ideas about how to do something. However, unlike patents, which end up being disclosed to the public, trade secrets must be maintained in secret or they lose their protectability. In order to be protectable as a trade secret, the idea or invention also must have value by being kept secret and must not be readily ascertainable by reverse engineering. Perhaps the most famous trade secret of all time is the Coca Cola® formula which has been shrouded in secrecy for over a century and contains a combination of ingredients that despite numerous attempts, cannot be determined by analyzing the final soft drink product.

Benesch has a full-service intellectual property group with attorneys experienced in all aspects of intellectual property law, including patents, trademarks, copyrights, and trade secrets, as well as intellectual property agreements and litigation. If you have further questions about the IP services that Benesch offers, please contact Jenny Sheaffer at 216-363-4453.

Contract Clauses: Fee-Shifting

Many contracts include negotiated fee-shifting clauses such as the following:

"In the event of litigation regarding or arising from this Agreement, the prevailing party shall be entitled to recover its reasonable attorneys' fees and costs incurred therein."

The language is pretty direct: If we win, you pay. However, attention should be paid to what the fee-shifting clause actually means.

- What is a "prevailing party"? Does this mean the party must win every claim? Is this determined on a claim-by-claim basis? What about cross-claims? Is the prevailing party an aggregate analysis, meaning it is the party that won the majority of the claims?
- What does the phrase "litigation regarding or arising from this Agreement" mean? Does it mean any action in connection with the Agreement? Does it mean that a party can receive attorney fees if it is seeking to enforce a right under the Agreement?
- What are "reasonable attorneys' fees"? Does this mean actual time billed? Does this mean the average amount an average party would spend on the litigation?

The meanings of the words and phrases in the fee-shifting clause may themselves be litigated, adding to each party's costs. A court will decide these meanings, and the court's interpretation of the meanings will likely be disparate from the drafters' original intent.

How can this risk be remedied? Because courts at the state and federal levels have not come to a uniform conclusion on these interpretations, additional detail in a contract may be warranted such as:

- Define "prevailing party." Is there a prevailing party to each claim rather an overall prevailing party?
- Clearly state what actions are worthy of the fee award. Just enforcement actions or any action related to the contract?
- Set forth guidelines as to what a court may consider when interpreting a "reasonable" fee award. Should the court consider the reasonableness of the time spent so long as it is commensurate with local attorneys of like expertise handling similar cases? What about the reasonableness of the rates of the attorneys handling the case and against what measure—expertise, geography, etc.?

Even if a matter is ultimately resolved through mediation or settlement, the fee-shifting provision will be a factor in each party's economic analysis of its claims against the other party and litigation risk.

Important Considerations for Private Equity Director–Representatives' Indemnification Rights

Recent Delaware cases highlight indemnification risks for private equity funds that have director-representatives serving on portfolio company boards.

Levy v. HLI Operating Company, Inc.: Indemnification Liability of Fund

In Levy v. HLI Operating Company, Inc.[i], former directors, including PE fund director-representatives, were named defendants in a securities lawsuit. The former PE fund director-representatives had indemnification agreements with both HLI, the portfolio company and the PE fund. The defendants settled the securities lawsuit, with the PE fund contributing $4.8 million in the settlement. The directors then sought indemnification and reimbursement on behalf of the PE fund from HLI for the $4.8 million.

The Delaware court held in part that, once a director has been indemnified by a third party, such as a sponsoring PE fund, the director cannot seek indemnification from the company on behalf of such third party seeking reimbursement; rather, the third party must directly pursue a contribution claim against the company.

The court in this case also determined that the PE fund and the portfolio company were co-indemnitors and thus each responsible for one-half of the indemnification obligation. The court stated that, although the PE fund could seek contribution from HLI, their respective indemnification obligations were co-equal and therefore the PE fund could only seek to recover one-half of the $4.8 million paid on the director-representatives' behalf.

Sodano v. American Stock Exchange: Secondary Liability

The court provided additional guidance in *Sodano v. American Stock Exchange LLC*[ii], and upheld the secondary liability approach in its Levy decision. Sodano, former chairman of the American Stock Exchange (AMEX), was entitled to both an advance of expenses and indemnification from AMEX and its parent company, the National Association of Securities Dealers (NASD). However, the NASD's certificate of incorporation included a section that provided for indemnification prioritization and set-off which, according to the court, showed a clear intent to render NASD's obligations secondary to the indemnification obligations of AMEX.

Because of this provision, the court held that the NASD and AMEX were not co-indemnitors with equal indemnification obligations, but rather that NASD was secondarily liable for advancing expenses and for indemnification obligations in situations where such obligation arose solely from the NASD's request that an individual serve at another entity.

Schoon v. Troy Corporation: Retroactive Repeal of Director-Representative Advancement Rights

In Schoon v. Troy Corporation[iii], the court held that a former director was not entitled to receive advances against expenses for indemnifiable claims where the company had amended its bylaws to exclude advancement rights for former directors before such advancement rights vested.

The court held that the advancement rights do not vest until the director is named in the suit for which advancement and indemnification are available, even if the actions or events giving rise to the suit occurred prior to the company's bylaw amendment.

Lessons

These three cases provide guidance to PE funds with representatives serving on portfolio company boards.

- Review all contractual arrangements and governance documents at both the PE fund and portfolio levels. Make sure primary and secondary liability is clearly set forth, both as to indemnity obligations and expense advances.
- Execute a written indemnification agreement between the director-representative and the portfolio company specifically and explicitly providing for fee advancement rights. If a company subsequently amends its bylaws to eliminate this right, the indemnification agreement will nonetheless provide contractual protection.
- Include PE fund veto or consent rights to amendments to the organizational documents that may reduce or restrict indemnification and advancement rights for PE fund director-representatives.
- Consider an agreement or side letter between the PE fund and portfolio company making clear primary and secondary liability and relative rights and obligations.

[i] *Levy v. HLI Operating Co., Inc., 924 A.2d 210* (De. Ch. 2007).
[ii] *Sodano v. AMEX LLC,* 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008).
[iii] *Schoon v. Troy Corp.,* 948 A.2d 1157 (Del. Ch. 2008).

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