INSIGHTS

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Using Earnouts to Find an Exit: A Seller's Perspective

The use of earnouts in today's mergers and acquisitions climate is fraught with risk and unintended consequences for unwary sellers. Highlighted below are common drafting pitfalls and legal and business considerations that sellers and sellers' counsel should consider before negotiating an earnout.

By Marc D. Mantell and Scott Dunberg

An "earnout" is a contingent payment that makes up a portion of the total purchase price in an acquisition. An earnout is realized when the target business achieves certain negotiated performance goals following the closing of the transaction. Earnouts generally are used to bridge the valuation gap created when a buyer and seller disagree on the value of the target business. In many cases, a buyer may be unwilling to accept seller management's rosy projections for future sales or the profitability of the target business. It also may be used when there is a recognized contingency, such as successful development of a new product, and neither party is prepared to speculate about the outcome. In these situations and others, an earnout may be the only way for the sellers to realize the value they believe exists in the business. The "valuation gap" can be especially prominent for early-stage companies, those focused on unproven products or technologies or other companies for which historical results may be unreliable indicators of future value.

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As Vice Chancellor Laster stated in *Airborne Health, Inc. v. Squid Soap, L.P.*:

> what an earnout (and particularly a large one) typically reflects is disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. In theory, the earnout solves the disagreement over value by requiring the buyer to pay more only if the business proves that it is worth more. But since value is frequently debatable and the causes of underperformance equally so, an earnout often converts today's disagreement over price into tomorrow's litigation over the outcome.[1]

Despite the myriad post-closing disputes arising from the use of earnouts, these structures continue to be used frequently in exit transactions, particularly for life sciences companies, which are often subject to heightened uncertainty due to pending clinical milestones or regulatory approvals.[2] Furthermore, a survey of recent non-life sciences deals has shown successful achievement of 50 percent of earnout milestone events,[3] which demonstrates that earnouts should not be dismissed as a mere "lottery ticket." While it may not be possible to completely remove the uncertainty and risk inherent in earnout provisions, sellers can realize significant future value by using earnouts if they are properly counseled about the pitfalls and limitations of earnouts and they undertake thoughtful risk assessment and prudent drafting.

Threshold Considerations for an Earnout

As an initial matter, sellers should consider whether an earnout is appropriate for a particular transaction. For example, careful consideration should be given to the target's capital structure. Are the investors venture or private equity funds? If so, where are the funds in their lifecycles and when do they need to return money to their limited partners? Does the company have an employee stock ownership plan or similar arrangement that would introduce unique complications in transactions involving contingent consideration?

How credit worthy is the buyer? The target's board may not be comfortable agreeing to a deferred payment structure without a letter of credit or escrow arrangement to support the buyer's contingent obligations. Sellers also should conduct diligence on the buyer's existing credit facilities and other key agreements to ensure that the buyer is not subject to any restrictive covenants that could prohibit the making of an earnout payment.[4]

Are the seller's board members comfortable with management projections, which will likely form the basis for an earnout? The seller's financial advisor should be consulted to model potential outcomes for the target business with a focus on industry, management, economic and other risks that could affect future results.

Sellers also should consider the tax treatment of contingent earnout payments. For example, when earnout payments are linked to continued employment of target management, those payments could be characterized as compensation rather than additional purchase price, resulting in unfavorable tax consequences. Additionally, earnout payments are often treated under the installment method for tax reporting. This treatment provides for deferral of tax on the earnout payments, but also may result in a delay in the seller's recovery of a portion of its tax basis in the sale, thus resulting in higher taxable gain on the up-front closing payment. Tax counsel should be consulted.

Are there any regulatory matters, such as a filing under the HSR Act, implicated by the size and/or structure of the earnout?[5]

Because these issues may require complicated (and expensive) solutions and necessitate additional or protracted negotiations, or simply render an earnout unworkable, the seller and its management should consider these threshold issues before expending time and money structuring and negotiating an earnout.

General Structural Considerations

The Performance Metric and Evaluating Performance

There are a number of ways to structure an earnout to measure post-closing performance.

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In many cases, the measure is simply a target for future revenues. Other financial measures also are commonly used, such as net income or some derivation of EBITDA that takes into account expenses incurred to operate the business. Sellers may be uncomfortable with a net income or EBITDA-based target unless they are given some control over the post-acquisition business, including its expenses. Many sellers prefer revenue-based targets, which can be simpler to measure and less likely to result in post-closing accounting disputes. According to the 2013 ABA Private Target Mergers and Acquisitions Deal Points study, 32 percent of earnouts were based on the revenue of the target company and 30 percent utilized an earnings or EBITDA-based measure.[6] Some earnouts are structured to trigger payments upon the achievement of non-financial targets such as a product launch or obtaining FDA approval for a drug or medical device.

Many sellers prefer revenue-based targets.

An earnout may be structured to track results attributable to a particular entity, such as the acquired entity in a stock sale or merger, or a particular business, product or set of products. Each structure presents risks to sellers that should be identified and managed. For example, a buyer should not be permitted to avoid counting revenues simply by moving some or all of the business into an affiliated entity. Sellers also should pay close attention to how the product is defined in the agreement to understand whether it would include similar products based on the same intellectual property in the event that the buyer develops improvements or related products that generate post-closing sales.

It is critical for the sellers to understand the buyer's plans for the acquired business and how it fits into buyer's existing businesses. For example, the buyer may have, or seek to acquire, similar products or businesses that may compete with the products or businesses that are subject to the earnout. If the acquired products may be packaged with other products, sellers should consider limiting the buyer's ability to offer certain discounts intended to increase sales of products that do not contribute to earnout performance.

It is critical for the sellers to understand the buyer's plans for the acquired business.

Accounting issues also play an important role in evaluating the post-acquisition performance of the acquired business or product line. For example, depending on the duration and structure of the earnout, the buyer may be incentivized to manipulate the recognition of sales from one financial reporting period to the next, especially if the acquired business sells fewer, more expensive products. Where an EBITDA-based measurement is used, sellers should understand in advance how expenses will be allocated across the buyer's businesses and which expenses should be excluded from EBITDA calculations. Failure to properly describe these exclusions in the acquisition document may result in a costly post-closing dispute.[7]

Many earnouts require the use of generally accepted accounting principles (GAAP) or accounting consistent with either the seller's or buyer's past practices. Sellers should be aware that GAAP allows for significant flexibility and thus unpredictable outcomes for sellers. Where references to GAAP are used, sellers should consider whether to freeze GAAP as of a certain date for purposes of the earnout, since future changes in GAAP could have a significant effect on earnout accounting. Similarly, a requirement for accounting to be consistent with past practice may not provide sufficient guideposts to ensure predictable application of accounting principles. In many cases, it may be appropriate to schedule in the transaction documents the specific line items, revenue recognition principles and other relevant methodologies that must be used for purposes of the earnout.

Calculating the Earnout Payments

An earnout is structured to trigger one or more payments to the sellers (in addition to the initial purchase price paid at the closing) if specified targets are achieved. This payment amount may be calculated as a percentage of revenues or EBITDA above the target, may be capped or may require the achievement of a minimum threshold before any payments are earned. Sellers typically will seek pro-rated payments for performance below target rather than a binary, pay or no-pay scenario. According to the Duff & Phelps 2012 Contingent Consideration Study, 73 percent of earnouts had a cap on earnout payments, 70 percent had a minimum performance threshold below which the earnout payment would be zero, and 30 percent had a multiple tier structure under which the rules for payments differed when each of multiple thresholds were achieved.[8]

What contractual protections might a seller have to ensure that the buyer will run the business to maximize earnout value?

Sellers also should consider an appropriate length for the earnout period. A longer period adds risk for sellers because it increases the chances of an unforseen intervening event that could hinder or prevent achievement of the earnout targets. That said, a longer horizon may be worth the risk for sellers of early-stage or turnaround businesses or life sciences companies, for which it may be difficult to accurately project a timetable for achievement of milestones.[9] According to the 2013 ABA Private Target Mergers and Acquisitions Deal Points study, 38 percent of deals had an earnout period of one year or less, 18 percent had a period of greater than one year but less than or equal to two years, 12 percent had a period of greater than two years but less than or equal to three years, and 12 percent had an earnout period of four years.[10] Additionally, if the sellers are relying on the buyer's sales representatives to sell the acquired products, it may be appropriate to delay the start of the initial earnout measurement period to allow time for training such sales representatives about the acquired business and new products. This would be particularly important for an earnout of shorter duration.

Sellers also should consider an appropriate length for the earnout period.

Measurement periods for longer earnouts typically are based on twelve-month periods following the closing of the transaction. Targets can be reset for each measurement period or cumulative over several periods. The parties also can agree to a formulation that averages periods of weak performance with periods of strong performance. A seller may negotiate for a payment structure with a "catch-up" provision that allows missed targets in a certain period—and, therefore, missed payments—to be achieved in subsequent periods, rather than being forfeited. This can be particularly advantageous for sellers of an early stage business, which may require a longer period of time to ramp up sales.

Seller Protections and Buyer Diligence Obligations

The post-closing operation of the business adds a large degree of uncertainty to the prospect and reliability of potential earnout payments. The sellers are vulnerable to the buyer's actions and decisions, even if made in good faith, which may adversely affect the acquired business and the likelihood of receiving earnout payments. A wary seller will ask itself what recourse it has against a buyer who dedicates inadequate resources to the acquired business and—more drastically—whether it is protected if the buyer simply stops trying to sell the products that count toward the earnout. In some cases, these concerns can be mitigated through the continuation of target management following the closing, especially if management will share in potential earnout payments. Even this advantage, however, can be undercut by the buyer's countervailing interests if managers are incentivized to devote resources to the buyer's other businesses that do not count toward the earnout. But what contractual protections might a seller have to ensure that the buyer will run the business to maximize earnout value?

In some cases sellers negotiate for more direct control over the post-closing business.

A seller can negotiate express contractual provisions governing the effort and resources that a buyer must commit to the acquired business. Many express covenants set forth a standard of "reasonable efforts" which the buyer must adhere to. The spectrum of "reasonable efforts" covenants spans from some minimum standard of effort that the buyer must undertake in managing the acquired business to the express promise to "maximize" the earnout payments. Similarly, a seller may seek a promise from buyer to operate the acquired business in good faith or, alternatively, to not take any actions in bad faith with the intent to avoid or reduce earnout payments. Neither of these standards alone offers much guidance as to what exactly a buyer may or must do—or not do—to satisfy its obligations. However, such provisions may provide the seller with some leverage in the event of a dispute.

Both sellers and buyers often will seek more clarity in defining how the buyer may satisfy its post-closing obligations to operate the acquired business. This clarity can be obtained by reference to historical practices of the seller, normal practices of the buyer for similar businesses or industry standards. The parties may seek even more specific covenants, such as a commitment from the buyer to maintain a minimum market spend, employ an adequate sales force dedicated to the product or maintain a certain sales commission structure payable on sales of an acquired product line or license.

In some cases sellers negotiate for more direct control over the post-closing business, either through negative operational covenants, which would require the consent of a seller representative or continuing target management before certain actions could be taken, including, for example, reducing sales force or incurring indebtedness. Sellers also may try to acquire approval rights over operating budgets, capital expenditures and accounting methods or assurances of adequate capital for existing operations and any projected expansion.

A recent survey showed that 60.5 percent of earnouts included some provision that restricted the buyer's discretion to operate the business.[11] A review of the survey data showed that 5 percent of these earnout provisions included a "reasonable efforts" provision, 11 percent included an express "good faith" provision, 24 percent included an express "no bad faith" provision, and 38 percent identified specific covenants or other requirements. Thirty percent of earnout provisions did not include any express diligence requirement and only 11 percent expressly provided the buyer with an unconditional right to operate the business with complete autonomy.[12] Sellers also may seek a seat on the board of directors of the buyer or an appropriate subsidiary of the buyer as a means of exercising some control over decisions affecting the acquired business and the earnout. Ultimately, the type of protective diligence covenant, if any, that the parties agree to will be dependent on a number of factors, including the negotiating leverage of the parties.

In certain cases, sellers may determine that the structure of the earnout or nature of the earnout milestones may render these types of covenants less important. For example, the 2012 SRS Life Sciences M&A Study found that life sciences deals with commercial or sales milestones were more likely than deals with developmental or regulatory milestones to have no diligence requirement or to expressly give the buyer discretion to operate the business without restriction.[13] Buyers will resist covenants that limit their flexibility to adapt or scale their businesses based on economic, market or industry forces and the proposal of diligence covenants often leads to protracted negotiations.

A seller may seek a promise from buyer to operate the acquired business in good faith.

Even if a seller successfully negotiates for one or more protective covenants, it may not be entitled to a meaningful remedy upon a breach of such a covenant without demonstrating causation and damages, unless specific remedies are provided for under the agreement. For example, in *Lapoint v. AmeriSourceBergen Corp.*, the court found that the buyer had breached its obligation to exclusively and actively promote the seller's products.[14] However, the court concluded that "even had [buyer] acted in utmost good faith, which it certainly did not, [seller] would have been highly unlikely to earn a sale and thus contribute to the EBITA calculations for purposes of the earnout" and thus only awarded the sellers nominal damages of six cents.[15] Sellers can try to negotiate for specified damages, such as an acceleration of the earnout payments, in the event of a breach of the buyer's operational covenants, although buyers tend to strongly resist such provisions.

In recent years, much attention has been paid to potential "implied" obligations governing the buyer's conduct of an acquired business subject to an earnout. Some courts have found that in cases where the purchase agreement is silent, or provides incomplete guidance regarding the buyer's obligation to run the acquired business, buyers have an implicit duty to operate the business in a particular manner.

In *O'Tool v. Genmar Holdings, Inc.*,[16] the court, applying Delaware law, upheld an award in favor of the sellers in an earnout dispute relying on the implied covenant of good faith and fair dealing. In *O'Tool*, Genmar, the world's largest recreational boat manufacturer, purchased a boat manufacturing company. The acquisition included an earnout that was linked to future sales by the acquired boat line. However, after acquiring the business, the defendants re-branded the acquired boat line, shifted production priority to its existing boats, denied the sellers operational control, discontinued the acquired boat line, and ultimately shut down the sellers' production facility. The court concluded that the district court's summary of the evidence was sufficient to demonstrate that the buyer's actions "frustrated and impaired" the realization of the earnout, which violated the implied covenant of good faith and fair dealing.[17] In affirming the trial court's finding that there had been a violation of the implied covenant, the court reasoned that despite a lack of express provisions restricting the buyer's actions, the obvious spirit of the contract was to give the sellers "a fair opportunity to operate the [acquired business] in such a fashion as to maximize the earnout."[18]

Some courts have found an implicit duty to operate the business in a particular manner.

In *Sonoran Scanners Inc. v. PerkinElmer Inc.*,[19] the U.S. Court of Appeals for the First Circuit, applying Massachusetts law, relied on a different theory of implied duties to find that the buyer was obligated to operate the acquired business in a manner that would make payment of the earnout more likely. PerkinElmer, Inc. purchased Sonoran Scanners, Inc. for $3.5 million at the closing and earnout payments tied to unit sales in the five years following the acquisition. In the subsequent five years, only one unit was sold and no additional amounts were paid to the seller. The sellers brought suit alleging that the failure of the business was the avoidable result of unreasonable and bad faith decisions by the buyer.[20] Despite the lack of any express reasonable efforts obligations on the buyer, the court found that the buyer had a duty to use reasonable efforts to develop and sell the acquired technology.[21] The Court reversed the decision of the district court on the grounds that there was adequate support for the existence of an implicit reasonable efforts term, based upon (1) the substantial size of the potential earnout payments relative to the closing payment, (2) the fact that most of the closing consideration was paid to the seller's creditors and not its shareholders, (3) the lack of explicit language in the asset purchase agreement disclaiming an obligation to use reasonable efforts, and (4) the lack of explicit language conferring on the buyer exclusive discretion in the operation of the business.[22]

In response to the these and other judicial decisions finding an implicit and seemingly indeterminate duty for buyers to operate acquired businesses in accordance with standards not expressly provided for in the terms of the acquisition agreement, counsel for buyers have included language in earnout provisions that purports to disclaim any obligation to operate the acquired business in any particular manner and waiving the seller's right to bring an action pursuant to an implied covenant.[23] According to the 2013 ABA Private Target Mergers and Acquisitions Deal Points Study, 15 percent of private target deals that contained earnouts in 2012 included an express disclaimer of any fiduciary relationship with respect to the earnout. This percentage increased from just 3 percent of deals in 2010.[24]

Though the *Genmar* and other implied duty cases have caused concern for buyers in understanding the extent of their potential obligations under an earnout, at least in Delaware, the doctrine of implied covenant of good faith and fair dealing may not offer much protection for sellers. As Vice Chancellor Laster noted in *Airborne v. Squid Soap*,[25] the implied covenant operates "only in that narrow band of cases where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but does not speak directly enough to provide an explicit answer. In the Venn diagram of contract cases, the area of overlap is quite small."[26]

The Delaware Supreme Court's recent decision in *Winshall v. Viacom International, Inc.*[27] demonstrated the difficulty sellers face in relying on an implied duty of a buyer to maximize earnout payments. In *Winshall*, the buyer had an opportunity to renegotiate a license agreement to reduce certain fees that would have resulted in a higher earnout payment to the sellers. The buyer did not take this opportunity and instead obtained other concessions from the licensee, which would not result in a higher earnout payment. The sellers asserted that under the merger agreement, the buyer had an implied obligation to take advantage of such an opportunity to increase the amount of the potential earnout payments. The court stated that for the sellers' implied covenant claim to succeed, "it must be clear from the Merger Agreement that Viacom and Harmonix would have agreed to take whatever steps were available and required to maximize the amount of the earnout. The parties to the Merger Agreement could have created such an obligation in their contract, but they did not. Nothing in the Merger Agreement states, or could be read to imply, that Viacom or Harmonix must conduct their businesses, post-merger, so as to maximize the amount of the Selling Shareholders' earnout payments."[28] According to the Court, the Court of Chancery properly concluded that the plaintiff's complaint did not state a valid claim for breach of the implied covenant of good faith and fair dealing.[29] The court's decision in *Winshall* further demonstrates its reluctance to interfere with the operations of an acquired business absent express contractual obligations. In sum, the words in the contract matter and sellers should not presume that a court will rewrite the contract to their advantage in the event of a dispute.

Access to Information and Dispute Resolution

Information and Oversight Rights

Earnout provisions typically require the buyer to provide the seller with a report at the end of each measurement period to allow the seller to understand whether—and to what extent—an earnout payment was earned for that period. Sellers should consider carefully what information should be included in the report in order to verify earnout calculations and determine if the business has been operated in conformity with any diligence covenants, as discussed above. Because it may be difficult to compel a buyer to disclose proprietary information relating to the post-acquisition business, sellers should negotiate express contractual obligations that clearly identify the type of, and procedures for obtaining, information related to the acquired business or earnout calculations.

Sellers also should have the opportunity to contest the results of an earnout following receipt of the report described above. If the sellers choose to dispute the results, they carefully should consider the potential arguments supporting their position and include each alternative argument in their response to avoid possibly forfeiting any such argument in subsequent litigation or other prescribed dispute resolution.[30] In addition, sellers should confirm that the agreement requires the buyer to make payments in respect of agreed-upon amounts while other amounts remain under dispute. Otherwise, a buyer may seek to increase its leverage in a dispute by holding such agreed upon amounts hostage and potentially limiting the seller's ability to fund its litigation costs.

Further, sellers may negotiate for additional progress reports or audit rights for the purpose of assessing the acquired business during the pendency of an earnout measurement period. For life-sciences deals involving developmental or regulatory milestones, these requirements may include in-person meetings and more frequent written reports. The seller also may want to ensure that there is a record retention requirement that extends beyond the earnout period, in the event of a dispute.

Dispute Resolution

Because the potential value of an earnout can be quite large relative to the value of the acquisition, determining whether an earnout payment has been earned and verifying the calculation of that amount can be a very contentious—and, ultimately, litigious—process.[31] A dispute resolution provision may provide an efficient path to resolution, but may result in unintended consequences.

Parties often include clauses that require any earnout dispute to be resolved through arbitration rather than litigation. Arbitration may provide a quicker and less costly resolution than litigation, though the costs of arbitration can add up quickly and may equal or exceed those of litigation in certain circumstances. In addition, arbitrators are often less likely than judges to allow extensive discovery, unless the scope of discovery is prescribed in the transaction document. In the case of an earnout dispute, most relevant information is in the hands of the buyer as current owner of the acquired business, and thus any limitations on discovery could hamper the seller's efforts to demonstrate that it is entitled to an earnout payment.

Some agreements require that disputes be submitted to an independent accountant or other party, whose conclusions will be deemed final, binding and conclusive. While this process has the benefit of certainty and limits the time and cost of resolving disputes, it may not be appropriate in certain circumstances based on the transaction or the scope of the provision. While an independent accountant may be well qualified to resolve disputes relating to the accounting of EBITDA or revenue recognition, the same independent accountant's opinion regarding the buyer's compliance with operational covenants may be less reliable, but nevertheless binding. Courts are unlikely to overturn the accountant's determination if the court finds that the accountant acted in good faith and consistent with such accountant's reading of the transaction document.[32]

Dispute resolution provisions should be given careful consideration in light of the factors that are likely to drive earnout disputes. The dispute resolution procedures that govern the acquisition agreement generally may not be appropriate. While rigid arbitration or independent accountant mechanisms may be an efficient means of resolving disputes, in some cases a more flexible approach will provide sellers with more options—and thus leverage—in the event of a dispute.

Issues Related to Buyer Stock Consideration

Most earnout payments are made in cash rather than stock.[33] Sellers typically will prefer cash earnouts, which avoid messy valuation and liquidity issues described in more detail below. However, if the buyer is concerned about future cash flow, it may insist, at a minimum, on the ability to choose whether to use stock to fulfill its obligations under the earnout. In addition, if the parties are seeking to have the sale transaction qualify as a tax-free reorganization, then some portion of any earnout payment may have to be made in stock under applicable tax rules.

Valuing the Consideration; Timing

There are a number of issues to consider if some or all of an earnout payment is to be made in the form of the buyer's stock. The first step is determining the value of the stock for purposes of calculating the number of shares issuable in respect of any future earnout payment. The parties could stipulate that the value of the buyer's stock at the closing of the transaction will be the value used for purposes of this determination. A fixed-value approach is simple and easy to administer and benefits the seller if the value of the buyer increases over time, perhaps due to the success of the acquired business. However, sellers should consider some form of anti-dilution protection in the event the buyer issues additional shares to finance the business or compensate employees during the intervening period.

Alternatively, the parties may agree to value the buyer's stock at a subsequent time, such as the time, or a period preceding the time, the earnout payment is earned, agreed-upon or made. If the buyer's stock is listed on a national securities exchange, its value may be determined by reference to its then-current trading price on the public market. If the buyer's stock is not publicly traded, or is subject to increased volatility due to inadequate trading volume, it may be appropriate to have the determination be made by an independent appraiser or in accordance with a predetermined calculation, such as a multiple of sales, book value, or some measure of net income. If the transaction is structured as a tax-free reorganization, the parties should consult tax counsel to insure that applicable requirements are met in connection with any earnout payments made in a combination of cash and the buyer's stock. Any valuation done by reference to the date on which the earnout payment is agreed to or made may encourage the parties, particularly the buyer, to manipulate the date of agreement or payment in order to seek the most favorable valuation for the stock. In order to avoid this type of manipulation, a seller will typically seek to have any subsequent valuation done by reference to a set date, such as the end of the relevant earnout period.

Resale of the Earnout Stock

If the buyer makes an earnout payment by issuing its stock to the seller in a private placement then the securities will be deemed "restricted securities" under the federal securities laws and the sellers will be unable to resell the shares unless the shares are registered by the buyer for resale or the resale complies with an exemption from registration. The earnout shares will be subject to these restrictions whether or not the buyer is a public reporting company. These restrictions on liquidity may be a significant concern for sellers expecting to sell the buyer's shares or venture funds that intend to distribute cash to limited partners.

In the absence of registration, the sellers may be able to rely on the safe harbor provided by Rule 144 to resell the earnout shares. Satisfying Rule 144 requires the observance of a holding period prior to resale and compliance with other restrictions, which depend on whether the buyer is a public reporting company and whether the sellers are affiliates of the buyer. Under Rule 144(d)(3)(iii), if certain conditions are met, the holding period for the earnout shares may be deemed to begin at the time of the closing of the transaction rather than the time of issuance following the earnout.[34] Securities law counsel should be consulted early in the process to ensure that sellers have a clear understanding of the liquidity limitations for any shares that may be issued in the earnout.

For publicly traded, or soon-to-be publicly traded, stock, sellers should consider negotiating for registration rights, including an obligation of the buyer to register the shares issued in connection with the acquisition on a resale registration statement within a certain period following the closing of the transaction. This becomes more important if the seller is or will become an affiliate of the buyer. The registration rights provisions should include a requirement of the buyer to include shares issuable in connection with future earnout payments on any such registration statement.[35] The purchase agreement also should contain a covenant requiring the buyer to list the earnout shares for trading on its primary exchange.

Additionally, if the sellers have or will have representation on the buyer's board or are otherwise made aware of material non-public information in connection with the administration of the earnout, liquidity may be further restrained by the need to comply with insider trading policies and laws (including frequent black-out periods).[36]

Other Considerations

Indemnification Obligations; Offsets

Sellers should pay close attention to the interplay between the earnout and the indemnification provisions of the acquisition agreement. Many buyers will insist on retaining the ability to satisfy any seller indemnification obligations by holding back payments earned under the earnout. These set-off provisions may permit set-off of non-final claims against earnout payments and often provide buyers with more leverage than they would otherwise have against escrowed funds. According to the 2013 ABA Private Target Mergers and Acquisitions Deal Points study, 68 percent of private target deals that contained earnouts in 2012 expressly provided for the buyer's right of set-off.[37] Sellers should understand whether these or similar provisions could undermine carefully negotiated limits on their indemnification obligations.

Change of Control of the Acquired Business

If the acquired business is subsequently sold to a third party, sellers will want some assurance that their bargained-for rights under the earnout will be given effect following the transaction. A buyer typically will resist agreeing to provisions that limit its flexibility to sell the acquired business or the buyer itself. Many purchase agreements provide that if the business or assets of the business are sold to a third party, the obligations of the earnout must be assumed by the acquiror. The parties also could consider a buy-out or acceleration right, which would allow the buyer to sell the business without burdening the acquiror with uncertain earnout obligations and ensures the seller a predetermined payout amount. According to the 2013 ABA Private Target Mergers and Acquisitions Deal Points Study, 21 percent of earnouts in 2012 contained an express acceleration upon a change in control, down from 35 percent of deals in 2010 and 33 percent of deals in 2008.[38] The buy-out price could be fixed at a maximum potential earnout payment, or determined in accordance with a formula, which may take into account whether the acquired business was on pace to hit the required earnout milestones prior to the change in control.

Conclusion

Though economic and industry trends will continue to affect the prevalence of earnouts in exit transactions, earnouts are common and are likely to remain common, particularly in the middle-market and in the life sciences industries. Yet, many sellers are not aware of either the pitfalls that compromise the value of an earnout or the many tools available to address and mitigate those risks. When armed with a firm understanding of the seller's business, counsel can seek appropriately tailored solutions to the earnout structure and mechanics that provide a seller with the opportunity to realize the future value it contemplates.

Notes

1. *Airborne Health, Inc. v. Squid Soap, L.P.,* 984 A.2d 126, 132 (Del. Ch. 2009).
2. A recent survey by Shareholder Representative Services LLC found that in 2012, 82 percent of biopharmaceutical deals and 84 percent of medical device deals included earnouts. *See* Shareholder Representative Services LLC, 2012 SRS M&A Deal Terms Study 19 (2012).
3. *See* Shareholder Representative Services LLC, 2013 SRS M&A Post-Closing Claims Study 5 (2013).
4. Many credit facilities contain restrictive covenants that could prohibit earnout payments. Additionally, under accounting rules, generally a buyer must recognize the fair value of the earnout as of the acquisition date and then re-measure this value as of each reporting date. *See* ASC 805 (Topic 805, Business Combinations), formerly Financial Accounting Standards Board (FASB) Statement 141. This accounting treatment may require the buyer to take impairment charges in subsequent periods that could also impair compliance with its financial ratio covenants. A recent study found that 36 percent of earnouts had a re-measurement of more than 25 percent after 1 year following the acquisition date. Duff & Phelps, 2012 Contingent Consideration Study: Earnout Structuring and Valuation 15 (2012).
5. A filing under the Hart–Scott–Rodino Antitrust Improvements Act of 1976, commonly known as the HSR Act, generally is required only if the value of the transaction and, in some cases, the size of the parties, exceed certain dollar thresholds. Where a portion of the purchase price is subject to an earnout, the parties will need to determine whether the fair market value of the purchased business exceeds the applicable thresholds, even if the purchase price payable at closing is below these thresholds. HSR counsel should be consulted to help the sellers avoid potentially significant fines for failing to make a required filing.
6. American Bar Association, 2013 ABA Private Target Mergers and Acquisitions Deal Points Study 20 (2013). In a separate study of earnouts, the Practical Law Company (PLC) found that about 47.4 percent of earnouts were based on revenues or sales by the target and 28.9 percent relied on an EBITDA-based measure. Practical Law Company, Survey of Earn-Outs in Recent Deals (Dec. 20, 2012), *http://us.practicallaw.com/1-523-2344?q=earn-out+survey*. Similarly, the Duff & Phelps 2012 Contingent Consideration Study found that 48 percent of earn-outs used a revenue-based measure and 38 percent used an earnings-based measure, most commonly EBITDA. Duff & Phelps, 2012 Contingent Consideration Study: Earnout Structuring and Valuation 9 (2012).
7. *See, e.g.*, *Comet Systems, Inc. Shareholders' Agent v. MIVA, Inc.*, 980 A.2d 1024 (Del. Ch. 2008) (holding merger bonus to seller's employees constituted "one-time, non-recurring expense" and should have been excluded from the target's costs for the purpose of computing the earnout).
8. Duff & Phelps, 2012 Contingent Consideration Study: Earnout Structuring and Valuation 10 (2012).
9. For earnouts of longer duration, if optionholders of the acquired business are participating in the earnout, care should be taken to ensure that it is structured to comply with Section 409A of the Internal Revenue Code.
10. American Bar Association, 2013 ABA Private Target Mergers and Acquisitions Deal Points Study 21 (2013). Similarly, a Practical Law Company survey found that 42.1 percent of deals had an earnout period of one year or less, 18.4 percent had a period of greater than one year but less than or equal to two years, 15.8 percent had a period of greater than two years but less than or equal to three years, and 15.8 percent had an earnout period of great than three years. Practical Law Company, Survey of Earn-Outs in Recent Deals (Dec. 20, 2012),

http://us.practicallaw.com/1-523-2344?q=earn-out+survey. According to the Duff & Phelps 2012 Contingent Consideration Study, the average duration for life science earnouts was 4.5 years, 36 percent of which had a duration of four or more years and approximately 10 percent of which had a duration of 10 years or more. Duff & Phelps, 2012 Contingent Consideration Study: Earnout Structuring and Valuation 11 (2012).

11. Practical Law Company, Survey of Earn-Outs in Recent Deals (Dec. 20, 2012), *http://us.practicallaw.com/1-523-2344?q=earn-out+survey*.

12. The percentages do not total 100 percent because in some cases the earnout provisions contained more than one type of covenant (*e.g.*, to use commercially reasonable efforts and to maintain adequate capitalization). According to the 2013 ABA Private Target Mergers and Acquisitions Deal Points study, 18 percent of private target deals that contained earnouts in 2012 included a covenant to run the business consistent with past practice, while only 6 percent included a covenant to run the business to maximize the earnout (down from 8 percent of deals in 2010 and 10 percent of deals in 2008). American Bar Association, 2013 ABA Private Target Mergers and Acquisitions Deal Points Study 22 (2013).

13. Shareholder Representative Services LLC, 2012 SRS Life Sciences M&A Deal Terms Study 18 (2012).

14. *See LaPoint v. AmeriSourceBergen Corp.*, No. 327-C, 23-24 (Del. Ch. Sept. 4, 2007). The merger agreement between the parties provided: "[Buyer] agrees to (and shall cause each of its subsidiaries to) exclusively and actively promote [seller's] current line of products and services for point of care medication safety. [Buyer] shall not (and shall cause each of its subsidiaries to not) promote, market or acquire any products, services or companies that compete either directly or indirectly with [seller's] current line of products and services." *Id*. at 4.

15. *Id*. at 8, 24.

16. *O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188 (10th Cir. 2004).

17. *Id*. at 1195-1197.

18. *Id*. at 1197; *see also Interwave Technology, Inc. v. Rockwell Automation*, Inc. No. 05-398 (E.D. Pa. 2005) (finding implied obligation of good faith and fair dealing applied to the performance of earnout).

19. *Sonoran Scanners, Inc. v. PerkinElmer, Inc.,* 585 F.3d 535 (1st Cir. 2009).

20. *Id*. at 537-538.

21. *Id*. at 543-545.

22. *Id*. at 544. The Court also rejected PerkinElmer's argument that an implied reasonable efforts obligation only exists in the case of an exclusive license arrangement. The Court stated that the lack of an exclusive licensing arrangement does not lessen the obligation of a purchaser of assets to use reasonable efforts. *Id*. at 543.

23. For an example of the language used by buyers in an attempt to avoid operation of implied covenants, see the comments to the ABA's 2004 Draft Earnout Agreement (being reviewed and updated by the ABA's Negotiated Acquisitions Committee Task Force revising the Model Stock Purchase Agreement).

24. American Bar Association, 2013 ABA Private Target Mergers and Acquisitions Deal Points Study 24 (2013).

25. *Airborne Health, Inc. v. Squid Soap, L.P.*, 984 A.2d 126 (Del. Ch. 2009). In *Airborne*, although the asset purchase agreement contained no express provision requiring [buyer] to expend time and money on marketing and developing the seller's business, the court reasoned that "[w]hen a contract confers discretion on one party, the implied covenant requires that the discretion be used reasonably and in good faith," and "[buyer] thus could not have refused arbitrarily or in bad faith to pursue the [seller's] business." The court ultimately found no violation of the implied covenant. *Id*. at 146-148.

26. *Id*. at 146.

27. *Winshall v. Viacom Int'l, Inc.*, C.A. No. 39, 2013 (Del. Oct 7, 2013).

28. *Id*. at 15.

29. *Id*. at 15-16.

30. For a good discussion of earnout dispute mechanics and the risks associated with failing to include alternative arguments in anticipation of dispute resolution, see *Winshall v. Viacom Int'l, Inc.*, in which the court found that the parties were bound by the accountants' determination that certain issues were not properly raised for resolution because they were not included in the parties' initial earnout notices. *Winshall v. Viacom Int'l, Inc.*, C.A. No. 6074-CS, 38-40 (Del. Nov. 11, 2011).

31. For a recent and colorful example, see the complaint in *Scherer v. Thermo Fisher Scientific Inc.*, Case 1:13-cv-01185 (Filed July 3, 2013). In the Complaint filed by the plaintiff, it was alleged that the defendant unlawfully, fraudulently and in bad faith, deprived the selling shareholders of millions of dollars in earnout payments in connection with a 2010 acquisition by ThermoFisher.

32. *See, e.g.*, *Winshall v. Viacom Int'l, Inc.*, C.A. No. 6074-CS, 38-40 (Del. Nov. 11, 2011).

33. For a recent stock earnout transaction, see the acquisition of MakerBot by Stratasys Ltd., announced on June 19, 2013, under which the former stockholders of MakerBot may receive either stock or cash, at Stratasys' election, of up to $201 million (based on the closing date stock price) upon achievement of certain milestones. Press Release, Stratasys Ltd., Stratasys to Acquire MakerBot, Merging Two Global 3D Printing Industry Leaders (June 19, 2013) *(http://investors.stratasys.com/releasedetail.cfm?ReleaseID=772534)*.

34. *See* 17 C.F.R. § 230.144 (2013). *See also* Silvar-Lisco, SEC No-Action Letter, 1984 WL 48378 (Oct. 19, 1984); Booz, Allen & Hamilton, Inc., SEC No-Action Letter, 1974 WL 8252 (Sept. 30, 1974).

35. *See* the SEC's Securities Act Forms C&DI #116.05 [Feb. 27, 2009], which specifically addresses the use of an S-3 resale shelf to register

yet-to-be issued (or earned) earnout stock following the consummation of a merger transaction.

36. Becoming a stockholder, especially a large stockholder, of a public company can introduce a number of complications, even if the buyer's stock is not traded on a national exchange. Separate SEC filing requirements under Section 13 and Section 16 of the Securities Exchange Act of 1934 apply to stockholders at different ownership thresholds. The potential issuance of an indeterminate number of additional shares from an earnout adds additional complications to this analysis.

37. American Bar Association, 2013 ABA Private Target Mergers and Acquisitions Deal Points Study 23 (2013). This figure increased from 62 percent of private target deals that contained earnouts in 2010. American Bar Association, 2011 ABA Private Target Mergers and Acquisitions Deal Points Study 23 (2011). The 2012 SRS Life Sciences M&A Deal Terms Study found that 87 percent of life sciences deals permitted the buyer to offset indemnification claims against earnout payments. Additionally, 46 percent of life-sciences deals with an earnout and an escrow required a portion of at least one earnout payment to be placed in escrow (if the escrow period is still pending), regardless of whether any claims have been made. Shareholder Representative Services, 2012 SRS Life Sciences M&A Deal Terms Study 15 (2012).

38. American Bar Association, 2013 ABA Private Target Mergers and Acquisitions Deal Points Study 23 (2013).

SECURITIES OFFERINGS

Do "At-the-Market" Stock Offerings Allow a Board to Comply with Its Duty to Price Stock Issued Under Delaware Law?

The 2013 amendment to Section 152 of the Delaware General Corporation Law allows a board to price securities issuances using a formula, but boards still face risk of non-compliance with their statutory duty to fix the consideration of stock issued in "at-the-market" equity programs.

By Albert H. Manwaring, IV and James T. Seery

In 2013, Section 152 of the Delaware General Corporation Law[1] was amended to clarify that a board of directors may discharge its duty to determine the amount of consideration "for which stock will be issued by approving a formula" to determine the stock price.[2] Thus, a formula, such as the average closing market price of the stock over a period of time, may determine the final sale price of the stock. The language in the amendment to Section 152 of the DGCL, referencing a formula to price stock issuances, was borrowed from Section 157(b) of the DGCL, which permits the use of a formula to determine the price of stock options. Some Delaware corporate law commentators have noted that the amendment to Section 152 will facilitate a board's approval of the issuance of stock or equity programs that determine the price of the stock being issued "at-the-market" or at prevailing market rates.

Since the 2008 financial crisis' debilitating effect on the financial markets, "at-the-market" (ATM) offerings have become a popular, cost-efficient alternative to large public underwritings for companies to raise capital anonymously over a period of time, and to obtain the best value for the stock at prevailing market prices. In a typical ATM program, the company issuing stock will set parameters for the offering, including a minimum offering price and maximum number of shares to be sold at the discretion of a broker-dealer at the highest prevailing market prices over a prescribed period of time.[3]

The amendment to Section 152 of the DGCL allows a board to approve stock issuances based on a future market value of stock on a particular day, an average market value over a specified time period in the future, or some other formula that would allow calculation of the stock price at a precise or fixed amount in the future. But, in a typical ATM offering, while the broker-dealer is seeking to sell the stock being issued at the highest market price, the stock is sold at the discretion of the broker-dealer at the prevailing market price on any given day during the prescribed period of time, subject to the minimum price set by the board. Thus, the prices in typical ATM offerings are not based on a formula that would establish a fixed stock price in the future, but rather are subject to the fluctuations of the prevailing market prices for the stock over the prescribed period of time. Accordingly, the amendment to Section 152 may not give a board assurance that it has complied with its statutory duty to approve stock issuances priced "at-the-market."

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The Delaware Courts have not yet been asked to decide whether a board complies with its statutory duty when it approves stock issuances priced "at-the-market" with a minimum offering price and maximum number of shares to be sold. Delaware precedent offers no assurance, however, that a board's duty to determine the price of stock issuances can be discharged by setting a floor or minimum price per share, and then delegating discretion to a broker, banker, or appraiser to depart upwards from the minimum price and fix the precise amount of consideration.[4] Accordingly, a typical ATM offering could possibly result in uncertainty regarding the authorization of the stock issuance.

There are dire consequences for defectively-issued stock. Defects in the authorization of stock could result in the putative shares being found void and a nullity, which in turn may affect the validity of subsequent corporate acts, even if invalidation would be inequitable.[5] In 2013, the DGCL was amended to permit ratification of defective corporate acts, and to vest the Delaware Court of Chancery with jurisdiction over matters relating to the cure of defective corporate acts.[6] Even with the availability of the self-help remedy to now cure defective corporate acts under the DGCL, the risks and potential liability to issuers, brokers, and investors in ATM offerings for defectively-issued stock are not comforting.

There are, however, two options available under Delaware law to price securities issuances in ATM offerings that provide some assurance that a board has satisfied its statutory duty to determine the price of stock issued under DGCL Section 152. The first option is for the board to form and delegate its power to a committee of the board to approve the price of stock issuances "at-the-market."[7] After a broker decides to sell stock at the prevailing market price on any given day, a pricing committee of the board is quickly contacted to perform the perfunctory act of approving the sale price between the broker's pricing of the sale and the sale's closing. This first option is both inefficient and impractical.

The second option is for the board to approve a maximum and minimum price for stock being issued, and to delegate to a broker to fix the exact price of the stock within the price range determined by the board. Whether this second option would allow a board to comply with its statutory duty to determine the price of stock issuances is, however, unclear under Delaware law. While the Delaware Court of Chancery has suggested that a range of prices or consideration delegated to a broker to fix the exact price of the stock within the range might satisfy a board's statutory duty, the acceptable size of the price ranges or consideration that would allow a board to fulfill its duty are unclear under Delaware Court of Chancery precedent.[8]

A typical ATM offering could possibly result in uncertainty regarding the authorization of the stock issuance.

In sum, while ATM offerings are an attractive method for issuers to raise capital in precarious financial markets, the benefits of ATM offerings present difficult issues for a board seeking to ensure compliance with its statutory duty to determine the price of the company's stock.

A Board's Duty to Price Stock Issuances

In requiring strict compliance with statutory formalities when a company issues stock, the Delaware Supreme Court has emphasized that the "'issuance of corporate stock is an act of fundamental legal significance having a direct bearing upon questions of corporate governance, control and the capital structure of the enterprise. The law properly requires certainty in such matters.'"[9] Chancellor Strine of the Delaware Court of Chancery has explained that "[t]his mandate is premised on a 'sensible assumption … the capital structure and ownership of corporations are matters of great importance and should be settled with clarity.' "[10] In the context of determining board compliance with statutory formalities in stock issuances, "law trumps equity."[11]

"To ensure certainty, [the Delaware General Corporation Law requires] board approval and a written instrument evidencing the relevant transactions affecting issuance of stock and the corporation's capital structure … ."[12] Section 152 of the DGCL requires a board to determine the " 'consideration … for subscriptions to, or the purchase of, the capital stock of a corporation.' "[13] Thus, in a sale of stock being issued to a purchaser, directors must approve the sale price of the stock.[14] The Delaware Supreme Court has emphasized that "[t]his duty is considered so important that the directors cannot delegate it to the corporation's officers."[15]

The Delaware Courts have not yet been asked to decide whether an ATM stock offering priced "at-the-market" with a minimum offering price and maximum number of shares to be sold complies with the DGCL. Delaware Court precedent offers no assurance, however, that a board's duty to determine the price of stock can be discharged by setting a floor or minimum price per share, and then delegating to a broker, banker, or appraiser the discretion to depart upwards from the minimum price and fix the sale price for the stock being issued.[16] For example, in the seminal case, *Field v. Carlisle Corp.*, former Vice Chancellor Seitz held that a board's setting an upper limit on the value of property to be received as consideration for the issuance of a company's stock is insufficient to discharge its duty to determine the amount of consideration for the stock issuance. Former Vice Chancellor Seitz reasoned that the company's board improperly had delegated its statutory duty to an appraiser to fix the value of consideration to be received for the company's stock, subject only to the upper limit on value.[17] Similarly, in fulfilling its duty to fix the consideration in a merger under DGCL Section 251(b), a board may not set a floor or minimum price per share, and then delegate to an investment banker or financial advisor the discretion to fix the merger price, subject only to the floor or minimum price.[18]

Thus, the typical ATM offering, in which a broker sells stock being issued at the prevailing market price subject to the minimum price set by the board, may possibly not comply with a board's duty to price stock issuances under DGCL Section 152. If stock is invalidly issued, the putative shares may be void and treated as a nullity for purposes of validating subsequent corporate acts[19]—if not ratified by the self-help remedy for defective corporate acts in new DGCL Section 204, or validated by the Court of Chancery under new DGCL Section 205.

DGCL Section 152 was amended in 2013 to clarify that a board may determine the price of a stock issuance by using a formula. Some Delaware corporate law commentators have noted that this amendment will help boards price securities issued in ATM offerings in compliance with their statutory duty under Section 152.[20] But, since the prices in typical ATM offerings are not based on a formula that would establish a fixed stock price in the future, the amendment does not go far enough to expressly allow a board to set a floor or minimum price in an ATM offering, and then delegate to a broker the discretion to depart upwards from the minimum price and fix the sale price based on an actual trade at a future prevailing market price.

Options for Board to Price Securities Issuances in ATM Offerings

Two options are available under Delaware law that provide some assurance that a board has complied with its duty to price securities issued in ATM offerings under DGCL Section 152. In the first option, a board approves the price of the shares sold in the ATM offering.

Since the process of securing approval from the whole board of the stock price after a broker decides to sell stock at the prevailing market price on any given day is impractical, the board is advised to form and delegate its power to a committee of the board to approve the price of stock issuances in the ATM offering.[21] In short, between the time that the broker decides to sell stock at the prevailing market price and the closing of the sale, a properly-authorized committee of the board would quickly execute a written consent approving a schedule of the sales on any given day.

The acceptable size of the price ranges or consideration that would allow a board to satisfy its statutory duty is unclear.

In addition to being inefficient, the pricing committee's act of approving the sale price between the broker's pricing of the sale and the sale's closing often is merely perfunctory due to the relatively limited time available for the committee to consider the sufficiency of the price of the stock being sold before the closing of the sale in an ATM offering. Thus, while providing technical compliance with a board's statutory duty to determine the price of the stock issuance, query whether the committee's perfunctory approval of the sale price serves the salutary Delaware corporate law policies, underlying a board's duty to determine the value of consideration in a stock issuance.[22] Moreover, since the putative shares are not validly issued under DGCL Section 152 until the committee approves the sale price, corporate issuers can only give qualified opinions that the putative shares being sold will be valid upon the committee's future authorization to issue the shares at the sale price in the ATM offering. Qualified opinions from an issuer concerning the validity of the issuance of its stock expose broker-dealers selling the stock in ATM offerings to greater risk of liability.

The second option is for the board to approve a maximum and minimum price for stock being issued, and to delegate to a broker to fix the exact price of the stock within the price range determined by the board. Since no Delaware Court has yet ruled that a price range or range of consideration discharges a board's statutory duty to determine the price of stock issued under DGCL Section 152, whether this second option would allow a board to comply with its statutory duty is unclear. But, Delaware case-law authorities, as well as the language of Section 152 itself, authorizing issuances for an amount of "consideration" (*e.g.*, which language does not limit the amount of consideration to a precise or exact price) suggest that a range of consideration delegated to a broker to fix the exact price of the stock "at-the-market" within the range might satisfy a board's statutory duty under DGCL Section 152.[23]

Further, the acceptable size of the price ranges or consideration that would allow a board to satisfy its statutory duty under DGCL Section 152 also is unclear. The Delaware Court of Chancery, however, has provided some guidance to help a board determine an acceptable price range for stock issuances.[24] While these guidelines do not provide a precise formula for acceptable ranges of consideration, they suggest that the smaller the range of consideration (based on the quantity of shares being issued multiplied by the range differential between the minimum and maximum price-per-share) and the larger a company's size or capitalization, the more likely that a board's determination of a range of consideration for an issuance of stock will satisfy its duty under DGCL Section 152.[25] In short, the smaller the price range or range of consideration and the larger the size of the company, the less likely that the spread in the price range will be significant, or of "real substance," mandating that a board consider the exact or precise price within the range under Section 152.[26]

In sum, the options available to a board seeking to ensure compliance with its duty to price securities issued in ATM offerings are either impractical, or of uncertain validity. Due to the limitations in these options and the rise in popularity of ATM offerings in response to the chaos in the financial markets, consideration should be given as to whether further amendment to Section 152 of the DGCL is appropriate to expressly permit board compliance with its statutory duty to determine the price of stock in ATM offerings.

Consideration should be given as to whether further amendment to Section 152 of the DGCL is appropriate.

Amendment of Section 152 to Facilitate ATM Offerings

One school of thought counsels against further amendment to Section 152 of the DGCL to facilitate a board's compliance with its statutory duty to determine the price of stock in ATM offerings. This school of thought reasons that longstanding Delaware case law, interpreting Section 152 and its statutory predecessors to require that a board of directors determine the amount of consideration for corporate stock issuances, is premised on acts of fundamental legal significance concerning the company's capital structure, control, and good corporate governance. Thus, capital structure and ownership of corporations are matters so fundamental to corporate control and governance that they must be settled by a board and with clarity under Delaware corporate law. As former Vice Chancellor Seitz emphasized in *Field*, while a board may employ financial advisors to help the board determine the amount of consideration to be received for issuance of the company's stock, these advisors are employed to aid the directors, but the board's discretion is not delegated to the financial advisors; instead, the final determination of the value of the consideration remains with the directors.[27]

Another school of thought posits, however, that further amendment of Section 152 to accommodate ATM offerings would comport with Delaware corporate law policies and is necessary to keep Delaware at the forefront of corporate law and the State of first choice for incorporation. ATM offerings continue to increase in popularity as an alternative to public underwritings for a company to raise capital anonymously and at the highest prevailing market prices in order to obtain the best value for its stock issuances and raise the most capital for its needs.

While facilitating a board's compliance with its statutory duty to determine the price of stock in ATM offerings may not be the determinative factor in deciding where to incorporate, faced with aggressive competition from other states to usurp the Delaware corporate law franchise, the ability to ensure that stock is issued validly in ATM offerings is certainly a factor to consider in the decision where to incorporate today. Indeed, Illinois, Maryland, New Mexico, and Pennsylvania have corporate statutes that expressly validate the issuance of shares in a typical ATM offering, in which the board sets a minimum offering price and maximum number of shares to be sold at the highest prevailing market prices over a prescribed period of time.[28]

The final determination of the value of the consideration remains with the directors.

Moreover, query whether a typical ATM offering undermines Delaware corporate law policies. When a board with the aid of its financial advisors has determined a minimum price or range of consideration that is acceptable to the board for a stock issuance to raise necessary capital, and then delegates to a broker to sell the stock at the highest prevailing market price above the minimum or within the range of consideration in order to obtain the best value for the company's stock, has not the board fulfilled its duty to maximize value in the company's capital structure, and met the interests of both the company and its existing shareholders? Indeed, an ATM offering allows the company the opportunity to obtain the highest price for its stock, raising the most capital to meet the company's requirements, while having the least dilutive effect on the value of the stock of existing shareholders. Finally, in comparing a pricing committee's perfunctory approval of a sale price between a broker's pricing of the sale and the sale's closing in an ATM offering, which option presently is being recommended by some Delaware counsel to ensure technical compliance with a board's statutory duty to determine the price of a stock issuance, the above method of board approval of a minimum price or range of consideration with the aid of financial advisors is more true to actually serving the salutary Delaware corporate law policies.

Conclusion

In sum, ATM offerings are an increasingly popular method for issuers to maximize their ability to obtain the best value for their stock in precarious financial markets while raising the most capital to meet their requirements. But, even with the 2013 amendment to Section 152 of the Delaware General Corporation Law, which allows boards to price securities issuances using a formula, ATM offerings continue to present difficult issues for a board seeking to ensure certainty regarding its compliance with its statutory duty to determine the amount of consideration to be received for stock issuances.

The board-pricing-committee and range-of-consideration options available to a board seeking to ensure compliance with its duty to price securities issuances in ATM offerings under Delaware law are impractical, inefficient, or of uncertain validity. Accordingly, due to the limitations in these options and the rise in popularity of ATM offerings, further amendment of Section 152 to expressly permit board compliance with its duty to price securities issuances in ATM offerings is warranted to maintain Delaware's preeminence in the corporate law arena.

Notes

1. Delaware General Corporation Law is hereinafter referred to as DGCL.

2. H.B. 127, 147th General Assembly 13, 79 Del. Laws, ch. 72, Section 3 (2013) (comment in legislative synopsis to amendment to DGCL Section 152). The amendment adds the following sentence to Section 152 of the DGCL: "The board of directors may determine the amount of such consideration by approving a formula by which the amount of consideration is determined." 8 *Del. C.* Section 152.

3. Barbara J. Endres & Kersti Hanson, *At-the-Market Offerings-Implications of Regulation M*, 43 Rev. Sec. & Commodities Reg. 1, 2 (2010). At-the-market offerings must comply with the requirements of Rule 415(a)(iv) under the Securities Act of 1933.

4. *Omnioffices, Inc. v. Kaidanow*, 2001 WL 1701683, at *11 (D.D.C. Sept. 12, 2001) (summary of Delaware cases, ruling that board may not satisfy its statutory duty to determine the price of its stock by setting a floor or minimum price per share, and delegating discretion to a third party to depart upwards to determine the precise amount of consideration for the stock being issued), *rev'd on other grounds,* 321 F.3d 165 (D.C. Cir. 2003).

5. *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136-37 (Del. 1991).

6. 8 *Del. C.* Sections 204, 205. H.B. 127, 147th General Assembly 13, 79 Del. Laws, ch. 72, Sections 4, 5 (2013) (legislative synopsis to amendment to DGCL Section 204 provides that "'defective corporate acts' and 'putative stock' shall not be void or voidable solely due to a 'failure of authorization', if ratified as provided in Section 204 or if validated by the Court of Chancery in a proceeding pursuant to new Section 205. Section 204 is intended to overturn the holdings in case law, such as *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991) and *Blades v. Wisehart*, 2010 WL 4638603 (Del. Ch. Nov. 17, 2010), that corporate acts or transactions and stock found to be 'void' due to a failure to comply with the applicable provisions of the General Corporation Law or the corporation's organizational documents may not be ratified or otherwise validated on equitable grounds.").

7. *See* John Mark Zeberkiewicz & Tiffany N. Piland, *Valid Issuance of Capital Stock*, 44 Rev. Sec. & Commodities Reg. 191, 196 (2011) (citing 8 *Del. C.* Section 141(c)).

8. *See Field v. Carlisle Corp.*, 68 A.2d 817, 821 (Del. Ch. 1949) (Seitz, V.C.).

9. *Grimes v. Alteon Inc.*, 804 A.2d 256, 261 (Del. 2002) (quoting *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991)).

10. *Blades v. Wisehart*, 2010 WL 4638603, at *10 (Del. Ch. Nov. 17, 2010) (quoting *Liebermann v. Frangiosa*, 844 A.2d 992 1004 (Del. Ch. 2002)), *aff'd sub nom. Wetzel v. Blades*, 35 A.3d 420 (Del. 2011) (TABLE).

11. *Blades v. Wisehart*, 2010 WL 4638603, at *10 (Del. Ch. Nov. 17, 2010) (citing *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991)), *aff'd sub nom. Wetzel v. Blades*, 35 A.3d 420 (Del. 2011) (TABLE), *but see* 8 *Del. C.* Section 204(a) (In 2013, the DGCL was amended to provide a self-help remedy: "no defective corporate act or putative stock shall be void or voidable solely as a result of a failure of authorization if ratified as provided in this section or validated by the Court of Chancery in a proceeding brought under Section 205 of this title").

12. *Grimes v. Alteon Inc.*, 804 A.2d 256, 261 (Del. 2002).

13. *Id.* (quoting 8 *Del. C.* Section 152); *Olson v. EV3, Inc.*, 2011 WL 704409, at *12-13 (Del. Ch. Feb. 21, 2011) ("longstanding Delaware case law interpreting Section 152 and its statutory predecessors requires that the board of directors determine the sufficiency of the consideration received for shares") .

14. *Grimes*, 804 A.2d at 261 (citing *Field v. Carlisle Corp.*, 68 A.2d 817, 818 (Del. Ch. 1949)).

15. *Id.* (citing *Field*, 68 A.2d at 818).

16. *Omnioffices, Inc. v. Kaidanow*, 2001 WL 1701683, at *11 (D.D.C. Sept. 12, 2001) (summary of Delaware case law that a "board's statutory duty to determine the price of its stock is not discharged by setting floor price per share"), *rev'd on other grounds,* 321 F.3d 165 (D.C. Cir. 2003); s*ee also Aveta Inc. v. Cavallieri*, 23 A.3d 157, 178 (Del. Ch. 2010) (setting a "dubious floor price and delegate[ing] to a financial advisor unfettered discretion to depart upwards" to fix the merger price for the stock of a company is an improper delegation of board authority).

17. *Field v. Carlisle Corp.*, 68 A.2d 817, 820-21 (Del. Ch. 1949) (Seitz, V.C.).

18. *Jackson v. Turnbull*, 1994 Del. Ch. WL 174668, at *4-5 (Del. Ch. Feb. 8, 1994), *aff'd*, 653 A.2d 306 (Del. 1994) (TABLE); *see also Clark Mem'l College v. Monaghan Land Co.*, 257 A.2d 234, 241 (Del. Ch. 1969) (directors setting minimum sale price for company's assets, and delegating to company's officers authority to fix terms and conditions of the sale, including the sale price of the assets, was an improper delegation of authority conferred on the board by the stockholders' resolution empowering the sale of the company's assets under DGCL Section 271(a)).

19. *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136-37 (Del. 1991).

20. *See, e,g.*, John F. Grossbauer and Mark A. Morton, *2013 Amendments to the Delaware General Corporation Law,* 1, 7 (July 26, 2013), available at *http://www.potteranderson.com/uploads/1183/doc/2013_Amendments_to_the DGGL_July_2013.pdf* (Section 152 "expressly permits the board of directors of a Delaware corporation to determine the amount of consideration by using a formula. This will facilitate pricing of securities issuances 'at the market.'").

21. *See* John Mark Zeberkiewicz & Tiffany N. Piland, *Valid Issuance of Capital Stock*, 44 Rev. Sec. & Commodities Reg. 191, 196 (2011) (citing 8 *Del. C.* Section 141(c)).

22. *See Grimes v. Alteon Inc.*, 804 A.2d 256, 261 (Del. 2002) (quoting *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991)).

23. *Field v. Carlisle Corp.*, 68 A.2d 817, 821 (Del. Ch. 1949) (Seitz, V.C.); *Omnioffices, Inc. v. Kaidanow*, 2001 WL 1701683, at *10 (D.D.C. Sept. 12, 2001), *rev'd on other grounds,* 321 F.3d 165 (D.C. Cir. 2003).

24. *See Field*, 68 A.2d at 821.

25. *See Field*, 68 A.2d at 821; *Omnioffices,* 2001 WL 1701683, at *10.

26. The following sample board resolution approves a range of consideration, incorporating a formula, that may be effective to discharge a board's statutory duty under Section 152 of the DGCL:

The Board of ___________ (the "Company") hereby authorizes the issuance of [QUANTITY] shares of the Company's common stock, par value 0.001 per share, for an amount of consideration to be determined in accordance with the following formula:

The Board authorizes [broker] to sell up to [QUANTITY] shares of the Company's common stock, par value 0.001 per share, at or above a minimum market price equal to $ X – ((5% of X) or $ Y per share) and at or below a maximum market price equal to $ X + ((20% of X) or $ Z per share) with X being the closing trade price per share on [DATE]. Sales should begin on or after the date of this Resolution, and shall continue until [DATE] [or to when all issued shares are sold].

27. *Field v. Carlisle Corp.*, 68 A.2d 817, 820 (Del. Ch. 1949) (Seitz, V.C.) (citing statutory predecessor to 8 *Del. C.* Section 141(e) which gives directors protection for their determination of the value of consideration when they rely upon the report of a financial advisor, appraiser, or other expert). Moreover, if Section 152 is amended to facilitate a board's compliance with its duty to price securities issuances in ATM offerings, query whether amendment of the Delaware General Corporation Law regarding the pricing of stock options (8 *Del. C.* Section 157(b)), rights and designations in classes and series of stock (8 *Del. C.* Section 151(a)), and board determinations of consideration for mergers and other acquisitions (8 *Del. C.* Section 251(b)) also would now be required?

28. *See* 805 ILL. Comp. Stat. 5/6.25(a) (board may price stock being issued by establishing "a minimum price or a general formula or method by which the price can be determined"); MD Code Ann., Corporations and Associations, Section 2-203(a)(2) (board may price stock being issued by setting "the minimum consideration for the stock … or a formula for its determination"); N.M. Stat. Section 53-11-18A (board may price stock being issued by establishing "a minimum price or general formula or method by which the price will be determined"); 15 Pa. C.S.A. Section 1523 (an officer may determine, "within limits, pursuant to a formula or method or subject to relevant criteria specifically prescribed by the board … price or consideration and other terms on which shares will be issued").

SECURITIES MARKETS

SEC Clears the Way for M&A Deal Making by Unlicensed Persons

SEC staff no-action letter lets unlicensed persons broker M&A deals and receive commissions without registering as broker-dealers. The letter addresses long-standing uncertainties and may head off pending congressional exemption from registration. State registration requirements, however, may still apply.

By Mark D. Fitterman, Ignacio A. Sandoval, David A. Sirignano and Steven W. Stone

On January 31, 2014, the staff of the Securities and Exchange Commission's (SEC) Division of Trading and Markets issued a no-action letter (the Relief) that permits a merger and aquisition (M&A) broker (as defined in the letter) to effect securities transactions in connection with the transfer of ownership of a privately held company without the M&A broker registering as a broker-dealer under Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act).[1] The Relief comes as Congress was considering amendments to the Exchange Act that would have exempted M&A brokers from broker-dealer registration on terms similar to those in the letter. Because the Relief is in the form of a no-action letter issued by the staff, and not an SEC agency position issued in the form of an exemption from registration, it occupies a unique legal status that is not necessarily binding on the states, the courts or on the SEC itself.

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The Relief

Meaning of M&A Broker and Privately-Held Company

Two main terms are defined for purposes of the Relief: (1) M&A broker and (2) privately-held company.

For purposes of the Relief, an "M&A Broker" is a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company to a buyer who will actively operate the company or the business conducted with the assets of the company.

A "Privately-Held Company" is a company that does not have any class of securities registered, or required to be registered, with the SEC under Section 12 of the Exchange Act, or with respect to which the company files, or is required to file, periodic information, documents, or reports under Section 15(d) of the Exchange Act. Unlike the pending bills in Congress, there is no limitation on the size of the company in the Relief.

Scope of the Relief

The Relief permits M&A Brokers to facilitate mergers, acquisitions, business sales, and business combinations (collectively, M&A Transactions) between sellers and buyers of privately held companies. Under the Relief, M&A brokers may:

- Advertise a Privately-Held Company for sale with information such as the description of the business, general location, and price range;

- Participate in the negotiations of M&A Transactions;
- Advise the parties to issue securities, or otherwise to effect the transfer of the business by means of securities, or assess the value of any securities sold; and
- Receive transaction-based compensation.

Representations

The Relief contains number of representations that M&A Brokers must comply with in connection with the Relief.

- *Inability to bind parties*. M&A Brokers may not bind parties to a transaction.
- *Prohibition on financing*. M&A Brokers may not provide financing for M&A Transactions, whether directly or indirectly through an affiliate. M&A brokers can, however, assist purchasers to obtain financing from unaffiliated third parties, but the M&A broker must comply with all applicable requirements, including as applicable, Regulation T,[2] and must disclose any compensation in writing to the client.
- *No handling of funds or securities.* The Relief prohibits M&A brokers from having custody, control, or possession of, or from otherwise handling funds or securities issued or exchanged in connection with, M&A Transactions or other securities transactions for the accounts of others.
- *No public offerings or shell companies.* The Relief is not available to M&A Transactions involving public offerings of securities. Any offer or sale of securities must be conducted in compliance with an applicable exemption in the Securities Act of 1933 (Securities Act). In addition, no party to an M&A Transaction may be a shell company[3] other than a business combination related shell company.[4]
- *Disclosures regarding dual representation.* If an M&A broker represents both buyers and sellers, it must provide clear written disclosure as to the parties it represents and obtain written consent from both parties to the joint representation.
- *Group representation.* An M&A broker can facilitate an M&A Transaction with a group of buyers only if the group is formed without the assistance of the M&A broker.
- *Control.* The Relief contemplates that a buyer (whether individually or as part of a group) will control and operate the company or business conducted with the assets of the business. Necessary control can be exhibited if a buyer, or a group of buyers collectively, has the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. Further, for purposes of the Relief, necessary control is presumed to exist if, upon completion of the transaction, the buyer or group of buyers has:
  - The right to vote 25 percent or more of a class of voting securities;
  - The power to sell or direct the sale of 25 percent or more of a class of voting securities; or
  - In the case of a partnership or limited liability company, the right to receive upon dissolution or has contributed 25 percent or more of the capital.
- *Operations.* In addition to the control requirements, a buyer, or a group of buyers, must actively operate the company or the business conducted with the assets of the company. The Relief states that a “buyer could actively operate the company through the power to elect executive officers and approve the annual budget or by service as an executive or other executive manager, among other things.” No M&A Transactions covered by the Relief may result in the transfer of interests to a passive buyer or a group of passive buyers.
- *Restricted securities.* Any securities received by a buyer or an M&A broker in an M&A Transaction will be restricted securities within the meaning of Rule 144(a)(3) under the Securities Act because the securities would have been issued in a transaction not involving a public offering.
- *Barred individuals.* M&A brokers (and, if an M&A broker is an entity, each officer,

director, or employee of the M&A broker) may not (1) have been barred from association with a broker-dealer by the SEC, any state, or any self-regulatory organization; and (2) be subject to a suspension from association with a broker-dealer.

Comparison to Previous No-Action Letter

The scope of the Relief and the associated representations signal a departure from the last SEC no-action letter in this area, the *Country Business* letter.[5] For instance, while in *Country Business* the brokers were only permitted to have a *limited* role in the negotiations, there is no such restriction in the Relief. Further, in *Country Business*, a selling company had to satisfy the size standards for a "small business" under regulations issued by the U.S. small business administration. There is no size limitation in the Relief. In addition, the Relief permits M&A Brokers to advise parties regarding the structure of the transaction, and in particular, whether securities should be issued as part the transaction, which was not permitted in *Country Business*. *Country Business* also required a conveyance of 100 percent of the selling company's equity securities. In contrast, the Relief uses a standard based on transference of control that, in some instances, is satisfied with a 25 percent threshold. Finally, the Relief is much more explicit regarding the ability of M&A Brokers to receive transaction based compensation that, although permitted in *Country Business*, was not as clear as in the Relief.

Extension to Private Equity Space?

One area of recent concern are broker status issues that the staff has suggested may arise from certain practices by private equity fund advisers. In an April 5, 2013, speech to the Trading and Markets Subcommittee of the American Bar Association, SEC staff indicated that the collection by advisers to some private equity funds of certain deal fees in addition to advisory fees could call into question whether those advisors are acting as unregistered broker.[6] The specific activities mentioned in the Private Fund Speech for which deal fees were collected included negotiating and structuring transactions in connection with an acquisition or disposition of a portfolio company. While the ability to engage in these activities without triggering the broker registration requirements may have been called into question by the Private Fund Speech and the SEC staff's withdrawal in 2000 of a 1985 letter that appeared to allow such activities in exchange for contingent compensation,[7] the Relief may provide more support for advisers to private equity funds seeking to receive such deal fees. Further, although the Relief is limited in application to transactions involving Privately-Held Companies, there is no size limitation on the Privately-Held Company or any limitation on who can act as an M&A Broker. Advisers to private equity funds that receive deal fees would have to consider whether other conditions in the Relief—such as the prohibition on handling funds or securities, the provisions regarding financing, and the provisions on independently organized groups—still limits the relevance of the Relief.

No-Action Letters versus Exemptions

The Relief is styled as a staff no-action letter and not as an exemption from registration. While the difference between a no-action letter and an exemption may appear nuanced, it is significant because of the legal status of each type of action. As a general matter, no-action letters address gray areas in the law and express assurances from SEC staff that they would not recommend enforcement action to the SEC against the person requesting the no-action letter if they engage in the certain types of conduct. In contrast, a person receiving an exemption will have a clear obligation to engage in, or refrain from, certain courses of action absent the exemption. In addition, exemptions under the federal securities laws are usually granted by the SEC, either directly or through authority delegated to the SEC staff.[8] In this connection, because a no-action letter is not an agency position, persons relying on the Relief should be mindful that it may not be legally binding on the courts or the states although they can have persuasive value as precedent.[9]

Pending Legislative Amendments

The timing of the Relief is interesting in light of recent efforts in Congress to consider similar relief. On January 14, for example, the House of Representatives passed H.R. 2774, the Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act.[10] On that same day, S. 1923 was introduced in the Senate, with a similar title and similar provisions.[11] Both bills, if adopted, would have amended Section 15 of the Exchange Act to exempt M&A brokers from the broker-dealer registration requirements under that act. The chart accompanying this article illustrates major differences between the no-action letter and the congressional bills.

In this regard, persons relying on the Relief should consider whether they still have a registration obligation under state law. In addition, if state securities regulators require registration despite the position expressed in the Relief, Congress may nevertheless have to exempt M&A Brokers from registration and pre-empt state law.[12]

Practical Implications

M&A brokers as well as buyers and sellers of Privately-Held Companies that intend to rely on the Relief should ensure that any respective agreements specifically address the terms and conditions outlined in the Relief. In particular, buyers or sellers should, as appropriate, receive representations and warranties from M&A brokers that among other things: (1) the M&A broker and its personnel are not subject to any bars from association with a broker-dealer or subject to any suspensions; (2) any group of buyers were not formed with the assistance of the M&A broker; (3) the M&A broker will not handle funds or securities nor directly or indirectly finance any part of the transaction; and

	Relief	H.R. 2774	S. 1923
Size of Company	No limitation on the size of a privately held company	Exemption limited to companies with earnings or gross revenues of less than \$25 million[1]	Exemption limited to companies with earnings or gross revenues of less than \$25 million
Control	Control measured using 25% threshold	Control measured using 20% threshold	Control measured using 20% threshold
Disclosures or availability of financials	No mention	Disclosures or availability required[2]	Disclosures or availability required
Persons barred from associating with a broker-dealer	Cannot rely on the letter	No prohibition	No prohibition

[1] More specifically, under both bills, a company's earnings before interest, taxes, depreciation and amortization would have to be less than \$25 million.

[2] Specifically, both bills provide that " if any person is offered securities in exchange for securities or assets of the eligible privately held company, such person will, prior to becoming legally bound to consummate the transaction, receive or have reasonable access to the most recent year-end balance sheet, income statement, statement of changes in financial position, and statement of owner's equity of the issuer of the securities offered in exchange, and, if the financial statements of the issuer are audited, the related report of the independent auditor, a balance sheet dated not more than 120 days before the date of the offer, and information pertaining to the management, business, results of operations for the period covered by the foregoing financial statements, and material loss contingencies of the issuer."

(4) any financing options presented by the M&A broker will not involve an affiliate. In addition, any agreements between an M&A broker and a buyer or seller of a Privately-Held Company should ensure that any agreements specifically prohibit an M&A broker from binding any of the parties.

M&A brokers, in turn, should ensure that any companies involved in an M&A Transaction come within the meaning of a Privately-Held Company and that they are not shell companies. In addition, M&A brokers should evaluate their other business activities to ensure that they do not separately trigger broker registration requirements.

Strict compliance with the terms of the Relief is important to lessen the risk that party would try void an M&A Transaction or renege on paying an M&A broker by invoking Section 29(b) of the Exchange Act,[13] which makes voidable any contract entered into in violation of the Exchange Act. In this connection, is not uncommon for courts to hear to contract disputes based, in part, on Exchange Act Section 29(b).[14] In addition, parties to an M&A Transaction, including M&A brokers, also should be mindful of provisions under state law that parallel Exchange Act Section 29(b). This latter point is of particular concern in states that may impose registration requirements on M&A brokers.

Notes

1. *M&A Brokers*, SEC No-Action Letter (Jan. 31, 2014 as modified on Feb. 4, 2014).

2. 12 C.F.R. 220 *et seq.*

3. A "shell" company is a company that (1) has no or nominal operations and (2) has (a) no or nominal assets, (b) assets consisting solely of cash and cash equivalents, or (c) assets consisting of any amount of cash and cash equivalents and nominal other assets. In this context, a "going concern" need not be profitable, and could even be emerging from bankruptcy, so long as it has actually been conducting business, including soliciting or effecting business transactions or engaging in research and development activities.

4. A "business combination related shell company" as a shell company (as defined in Rule 405 of the Securities Act) that is (1) formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity solely within the United States or (2) formed by an entity defined in Securities Act Rule 165(f) among one or more entities other than the shell company, none of which is a shell company.

5. *Country Business, Inc.*, SEC No-Action Letter (Nov. 8, 2006).

6. *See* David W. Blass, Chief Counsel, Division of Trading and Markets, SEC, Remarks at American Bar Association's Trading and Markets Subcommittee Meeting: A Few Observations in the Private Fund Space (Apr. 5, 2013), available at *http://www.sec.gov/news/speech/2013/spch040513dwg.htm* (Private Fund Speech).

7. *See Dominion Resources, Inc.* SEC Staff No- Action Letter (Aug. 24, 1985) (taking a no-action position for business that assisted corporate and government issuers in the structuring and issuance of securities transactions in exchange for contingent compensation), revoked by *Dominion Resources, Inc.*, SEC Staff No-Action Letter (Mar. 7, 2000).

8. *See*, *e.g.,* 17 C.F.R. 200.30-3(a)(6) (delegating to the Director of the Division of Trading Markets, the ability to grant exemptions from, among other things, Rules 101, 102, 104, and Rule 105 under Regulation M).

9. *See, e.g.*, *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 427 n.19 (D.C. Cir. 1992) (principle of deference to agency views does not apply to no-action letters as they are not formal agency positions). *See also* SEC, Staff Interpretations, available at *http://www.sec.gov/interps.shtml* (stating that "staff interpretations provide guidance to those who must comply with the federal securities laws. However, because they represent the views of the staff, they are not legally binding.").

10. H.R. 2774, 113th Cong. (2014).

11. S. 1923, 113th Cong. (2014).

12. *See*, *e.g.*, National Securities Markets Improvement Act (NSMIA) of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (pre-empting states from imposing certain additional requirements on registered broker-dealers); Section 15(i) of the Exchange Act (codified provisions of NSMIA).

13. Exchange Act Section 29(b) reads in relevant part: "Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation…"

14. *See*, *e.g.*, *Couldock & Bohan, Inc. v. Société Generale Securities Corp.*, 93 F. Supp. 2d 220 (D. Conn. 2000); *Salamon v. Teleplus Enterprises, Inc.*, 2008 WL 2277094 (D. N.J. 2008); *Cornhusker Energy Lexington, LLC v. Prospect Street Ventures*, 2006 WL 2620985 (D. Neb. 2006).

EARNINGS PER SHARE

Post-Year-End Offerings

By Stuart Gelfond and Paul Tropp

Certain issues arise when a company wishes to file a registration statement and undertake an offering during the first quarter of the year (*i.e.*, after December 31st for companies with a fiscal year-end of December 31st) but before the company's year-end financial statements are complete. In particular, a company should focus on the financial statements that are required to be included (or incorporated by reference) in its registration statement and the comfort that the company's accountants may be willing to provide on the financial information contained in the registration statement, as well as comfort with respect to the period of time after the date of that financial information.[1]

Financial Statements

When a company prepares a registration statement after its fiscal year-end, which is often December 31, it is important to understand when the company's financial statements go "stale" so that the proper financial information can be included in the registration statement. A company will need to time the offering so that the company's registration statement is declared effective prior to the date on which the relevant financial statements become stale.[2] In addition, the company's accountants will not consent to, and the Securities and Exchange Commission (SEC) likely will not begin its review of, a filing, unless the financial statements included in the registration statement are in compliance with the staleness rules under Regulation S-X as of the filing date.

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Financial statements in a registration statement are tested for staleness by the number of days between the date of the financial statements in the filing and the effectiveness date of the registration statement.[3] Generally, financial statements go stale (other than third quarter financials as described below) under applicable SEC rules 135 days (or 130 days in the case of large accelerated filers and accelerated filers) after the date of the most recent balance sheet presented in the registration statement.[4] It is important to note that a filing may be made on the next business day if the last day before financial statements go stale is on a weekend or U.S. federal holiday. It also is important to note that the staleness rules under Regulation S-X vary for different types of companies (*e.g.*, large accelerated filers,[5] accelerated filers,[6] initial filers,[7] delinquent filers,[8] and companies without current net income[9]).

The first chart accompanying this article lists when third quarter and year-end financial statements go stale for companies with a December 31 fiscal year-end.[10] The financial statements referenced go stale at the close of business on the following dates (or the next business day, if the date falls on a weekend or holiday).[11]

Comfort Letters

Even when a company has the proper financial statements available to be included in the registration statement, it still may face problems when attempting to commence an offering post-year-end. When a company prepares a registration statement after its December 31 fiscal year-end, but before formally issuing its

	Date	Which Financial Statements Go Stale?
1.	February 14	Third quarter financial statements for initial filers, delinquent filers and companies without current net income. (Updated annual audited financial statements must be included when the number of days between the effectiveness date of the registration statement and the fiscal year-end exceeds 45 days.)
2.	March 1 (+)	Third quarter financial statements for large accelerated filers that are not delinquent filers or companies without current net income. (Updated annual audited financial statements must be included when the number of days between the effectiveness date of the registration statement and the fiscal year-end exceeds 60 days.)
3.	March 16 (+)	Third quarter financial statements for accelerated filers that are not delinquent filers or companies without current net income. (Updated annual audited financial statements must be included when the number of days between the effectiveness date of the registration statement and the fiscal year-end exceeds 75 days.)
4.	March 31 (+)	Third quarter financial statements for all other filers. (Updated annual audited financial statements must be included when the number of days between the effectiveness date of the registration statement and the fiscal year-end exceeds 90 days.)
5.	May 9 (+)	Year-end financial statements for large accelerated filers and accelerated filers. (First quarter financial statements must be included when the number of days between the effectiveness date of the registration statement and the date of the year-end financial statements in the filing exceeds 129 days.)
6.	May 14 (+)	Year-end financial statements for all other filers. (First quarter financial statements must be included when the number of days between the effectiveness date of the registration statement and the date of the year-end financial statements in the filing exceeds 134 days.)
(+) In leap years, these deadlines are one day earlier (*e.g.*, February 29 instead of March 1, and so on).		

year-end financial statements, as the company's audited financial statements are not yet available, they cannot be included in the registration statement. However, underwriters want to be sure that the registration statement does not contain material misstatements and therefore will want to conduct due diligence to confirm that there are no surprises in the fourth quarter (or after year-end). In addition, underwriters often want to include "flash" fourth quarter or year-end numbers because the marketing of the transaction will require a "recent developments" section. Accordingly, the underwriters may request that the registration statement contain up-to-date financial information—and will want to receive comfort from the company's accountants that such information is accurate. Furthermore, issues often arise related to the willingness of the company's accountants to perform comfort procedures on any information relating to periods after the conclusion of the third quarter not included in the registration statement or on any "capsule financial information" (*i.e.*, financial information for the recently ended fourth quarter and fiscal year) included in the registration statement.[12]

The underwriters will request "bring-down" comfort from the company's accountants that certain key line items (*e.g.*, revenue, net income) did not decline in the period since the last financial statements as compared to the comparable period in the prior year. Often the accountants will not provide bring-down comfort for periods after 134 days following the end of the third quarter, which can make it difficult to price an offering after that date (*i.e.*, after February 11th for companies with a fiscal year-end of December 31st) if the company's year-end audited financial statements are not yet issued. The AICPA's Codification of Statements on Auditing Standards AU-C Section 920 (codifying Statement on Auditing Standards No. 72, "Letters for Underwriters and Certain Other Requesting Parties") (SAS 72) only allows accountants to provide negative assurance for a period no more than 134 days following the end of the most recently audited or reviewed period (though it may be possible for them to provide other types of comfort after this date).

Given these issues, which are described in more detail in a white paper issued in 2005 by the AICPA,[13] it is important for companies wishing to engage in a transaction after December 31 to carefully consider the financial information included or incorporated by reference in the offering document and to discuss with the company's accountants the types of comfort that they expect to be able to provide on that information before making a decision regarding the timing of a proposed offering. In our experience, each accounting firm has its own internal policies on these issues, and, according to the white paper, the comfort provided in each case remains subject to the professional judgment of the company's accountants. Therefore, it is critical to discuss these points with the company and its accountants up front. The underwriters will need to determine whether the level of comfort to be provided is acceptable and within market norms, and determine any additional diligence procedures they will need to undertake. A company's CFO may need to provide an officer's certificate for periods not covered by the comfort letter.

The second chart accompanying this article lists the types of comfort procedures that are often requested on the capsule financial information, with a discussion of the comfort accountants typically may provide (which is based on the AICPA white paper):

	Comfort Requested	Discussion
1.	AU-C Section 722 (codifying Statement on Auditing Standards No. 100, "Interim Financial Information") (SAS 100) negative assurance on the full-year capsule information.	Not permitted pursuant to SAS 100, which only applies to interim financial information.
2.	SAS 100 negative assurance on the fourth quarter capsule information.	When the accountants have conducted a SAS 100 review, they may give negative assurance on the underlying interim financial information, provided that they state that the information has not been audited and that they cannot express an opinion thereon, and provided that fourth quarter financial statements are attached to the comfort letter. In addition, accountants typically may only provide negative assurance on such information when audit fieldwork is "substantially complete" and the year-end financial statements are in "substantially final form" (as determined using the accountants' professional judgment). However, the company should note that the fourth quarter information is subject to change, and the company may not state that the information is final.

(Continued)

3.	Reading the fourth quarter information and reporting changes in certain specified financial elements.	Pursuant to SAS 72, accountants may provide negative assurance that they have read the fourth quarter information and that they are aware of certain changes in amounts. Accountants typically provide this comfort on the fourth quarter only when audit fieldwork is substantially complete (though the financial statements do not yet need to be in substantially final form). Comfort may be provided on a shorter period within the fourth quarter (*e.g.*, one or two months), even if the audit fieldwork is not substantially complete.
4.	Inquiring of company officials regarding changes in certain specified financial elements.	SAS 72 permits accountants to provide negative assurance that they have inquired of company officials and that they are unaware of certain changes in financial statement line items no more than 134 days following the end of the most recent period for which an audit or review has been performed. When the cut-off date is year-end, accountants typically may only provide such negative assurance after audit fieldwork is substantially complete; however, when the cut-off date is not year-end, accountants may provide comfort, even if work is not substantially complete.
5.	Agreeing fourth quarter or full-year capsule financial information to the company's accounting records (*i.e.*, providing "tickmark" comfort).	Accountants may agree unaudited information to the company's accounting records if an audit of the company's financial statements for a period including or immediately prior to the unaudited period has been performed, or if the accountants otherwise have knowledge of the company's internal controls. This type of comfort will typically be given only after audit fieldwork is substantially complete (though the financial statements need not be in substantially final form).
6.	Positive assurance that the year-end capsule financial information has been audited.	Accountants may not comment on the completeness of the audit prior to the issuance of the company's financial statements[14] because both the accountants and the company are responsible for evaluating subsequent events up to the issuance date.

Conclusion

It is critical to consider the issues discussed above when planning a post-year-end transaction, because considerations related to the availability of the company's financial statements and the comfort its accountants will provide can significantly affect the timing of a proposed offering. Furthermore, the ability to do an offering may depend on where the company's accountants are in their auditing procedures with respect to the year-end audit.

Notes

1. Note that this memo addresses timing issues related to U.S. reporting companies and does not cover foreign private issuers.

2. Note that, in a non-shelf context, an offering may be priced within 15 days of the registration statement being declared effective, although underwriters typically will not price more than one day after effectiveness.

3. In the case of a Rule 144A offering, this period is typically analogized to equal the number of days between the date of the latest balance sheet presented and the pricing date.

4. To the extent a company is contemplating doing a shelf take-down, it already will have an effective registration statement. Since periodic report deadlines will for most periods be up to a few days after the staleness deadline, for shelf take-downs, it may be possible to do an offering off an already effective shelf registration statement even though a registration statement could not go effective and periodic reports may not yet be filed. In these situations, conversations should be had with transaction participants and accountants well in advance.

5. A "large accelerated filer" is a company that (i) has an aggregate market value held by non-affiliates of $700 million or more, as of the last business day of the company's most recently completed second fiscal quarter, (ii) has been subject to SEC reporting under the Securities Exchange Act of 1934, as amended (the Exchange Act) for at least 12 months, (iii) has filed at least one annual report under the Exchange Act, and (iv) is not eligible to use the requirements for smaller reporting companies in Regulation S-K.

6. An "accelerated filer" is a company that meets the other conditions specified in footnote 5 above for a large accelerated filer, but has an aggregate market value held by non-affiliates of $75 million or more, but less than $700 million, as of the last business day of the company's most recently completed second fiscal quarter.

7. An "initial filer" is a company that previously was not subject to SEC reporting requirements, and would include IPO issuers and voluntary filers.

8. A "delinquent filer" is a company that is subject to the SEC's reporting requirements, but has failed to file all of the reports pursuant to Section 13 or 15(d) of the Exchange Act that are due in a timely fashion.

9. A "company without current net income" is a company that does not expect to report positive income after taxes but before extraordinary items and the cumulative effect of a change in accounting principle for both (i) the most recently completed fiscal year and (ii) at least one of the two previous fiscal years.

10. For filers whose fiscal year-end is a date other than December 31, the dates will need to be adjusted accordingly.

11. When the expected effective date of the registration statement falls within the number of days described from the fiscal year-end, the filing must include financial statements through the third quarter, unless the audited financial statements for the fiscal year are available or unless the expected effective date falls after 45 days from the fiscal year-end and the issuer is a company without current net income. *See* footnote 9.

12. Similar issues may arise in 144A offerings. Accountants will not provide comfort on ranges for fourth quarter or year-end financial information.

13. *See* "Comfort Letter Procedures Relating to Capsule Information Presented in a Registration Statement Prior to the Issuance of the Year-End Financial Statements," American Institute of Certified Public Accountants, Inc., 2005.

14. The AICPA white paper, quoting the SEC staff in EITF Topic No. D-86, notes that the "'[i]ssuance of financial statements … would generally be the earlier of when the annual or quarterly financial statements are widely distributed to all shareholders and other financial statement users or filed with the Commission.' Financial statements would not be considered issued as of the date of either an earnings release or posting of financial statements to the registrant's web site."

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Akin, Gump, Strauss, Hauer & Feld LLP
Washington, DC (202-887-4000)

Practice Tips for M&A Practitioners for 2014 (January 23, 2014)

A discussion of practical tips regarding drafting of contractual provisions and complying with technical and statutory requirements based on a number of cases decided by the Delaware courts in 2013.

Cybersecurity Update: Are Data Breach Disclosure Requirements on Target? (January 16, 2014)

A discussion of cybersecurity risk factor disclosures by public companies and renewed Congressional interest in federal data security and breach notification legislation.

Alston & Bird LLP
Washington, DC (202-756-3300)

SEC Issues Staff Report on Review of Regulation S-K (January 7, 2014)

A discussion of the SEC staff report regarding its review of the disclosure requirements of Regulation S-K, as required by Section 108 of the JOBS Act. The staff identifies a number of disclosure areas for further review and recommends a comprehensive approach to such a review.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

Preparing Your 2013 Form 20-F (January 23, 2014)

A discussion of considerations for the preparation of the annual report on Form 20-F by foreign private issuers, including disclosure developments and continued areas of focus by the SEC.

Day Pitney LLP
New York, NY (212-297-5800)

So You Want to Be a Crowdfunding Portal? Top 10 Traps for the Unwary

A discussion of things to keep in mind under the SEC's proposed crowdfunding rules and otherwise before considering becoming a crowdfunding portal.

DLA Piper
Phoenix, AZ *(www.dalpiper.com)*

SEC Enforcement Cases to Increase in 2014: 4 Things Public Companies Need to Know (January 13, 2014)

A discussion of a potential change in the downward trend of the SEC bringing financial fraud cases.

Edwards Wildman Palmer LLP
Washington, DC (202-478-7370)

The "Municipal Advisor Rules"—Why Municipal Bond Market Participants Should Care (January 2014)

A discussion of the SEC's final rules relating to the registration of municipal advisors that the SEC will begin enforcing on July 1, 2014, and guidance issued by the SEC staff on January 10, 2014, in the form of frequently asked questions. In addition, the memorandum discusses the Municipal Securities Rulemaking Board's issuance of proposed Rule G-42, *Duties of Non-Solicitor Municipal Advisors,* which is intended to define the contours of a municipal advisor's fiduciary responsibilities.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)

2013 Year-End Update on Corporate Deferred Prosecution and Non-Prosecution Agreements (January 7, 2014)

A discussion of: (1) the DPAs and NPAs announced in 2013 and the trends they reflect; (2) the role these agreements play in federal civil litigation; and (3) the debarment and suspension implications of these agreements.

Greenberg Traurig LLP
Washington, DC (202-331-3100)

Section 162(m): Actions That Should Be Taken by March 31, 2014, and/or in This Year's Proxy to Avoid the $1,000,000 Deduction Limitation (January 2014)

A discussion of the things that public companies need to do early this year to minimize or avoid the application of the deduction limitations imposed by Section 162(m) of the Internal Revenue Code.

Holland & Hart LLP
Denver, CO (303-295-8000)

Prepare for a Fast-Paced Year of Conflict-Minerals Compliance (January 9, 2014)

A discussion of pending deadlines and trends in conflict minerals compliance and implementation, as well as the status of pending litigation challenging the SEC's conflict-minerals rules.

K&L Gates LLP
Pittsburgh, PA (412-355-6500)

In Mary Jo White's Own Words: Ten Changes to Expect from the SEC's New Enforcement Program (January 13, 2014)

A discussion of ten expected changes in the SEC's enforcement program, including targeting gatekeepers, bringing cases for minor, unintentional infractions, suing more individuals, and demanding more admissions.

Morrison & Foerster LLP
New York, NY (212-468-8000)

Broker-Dealer Cybersecurity: Protect Yourself or Pay the Price (January 10, 2014)

A discussion of FINRA's focus on cybersecurity as a priority in 2014, given the issues reported across the financial services industry, including the increasing frequency and sophistication of attacks on the nation's largest financial institutions.

Paul, Weiss, Rifkind, Wharton & Garrison LLP
New York, NY (212-373-3000)

SEC Announces 2014 Examination Priorities (January 10, 2014)

A discussion of the examination priorities announced by the SEC's National Examination Program for 2014 for investment advisers to hedge funds and private equity firms, which include conflicts of interest, marketing/performance, and safety of assets and custody.

Ropes & Gray LLP
Boston, MA (617-951-7000)

U.S. Administrative Law Judge Suspends Chinese Affiliates of "Big Four" Accounting Firms (January 24, 2014)

A discussion of the Administrative Law Judge's decision in the dispute between the SEC and the Chinese affiliates of the "Big Four" accounting firms, in which she suspended the affiliates for six months for refusing to turn over audit documents of certain U.S.-listed Chinese companies under investigation by the SEC.

Schulte Roth & Zabel LLP
New York, NY (212-756-2000)

SEC Releases a Second Installment of "Bad Actor" Rule Guidance (January 22, 2014)

A discussion of SEC Division of Corporation Finance guidance in its Compliance and Disclosure Interpretations addressing some of the questions raised by private fund managers (and others) regarding the "bad actor" disqualification provisions of Rule 506(d).

Sullivan & Cromwell LLP
New York, NY (212-588-4000)

SEC Staff Issues Guidance on Unbundling Proposals: ISS Addresses Third-Party Director Compensation, Publishes Updated QuickScore Metrics, Opens Data Verification Period, Requests Comments for Longer-Term Policy Changes, and Issues Other New Policies (January 30, 2014)

A discussion of recent developments that U.S. public companies should be aware of as they plan for the 2014 proxy season.

Sutherland, Asbill & Brennan LLP
Atlanta, GA (404-853-8000)

SEC's Examination Program Issues a Risk Alert on Investment Adviser Due Diligence Processes (January 31, 2014)

A discussion of Risk Alert issued by the SEC Office of Compliance Inspections and Examinations entitled "Investment Adviser Due Diligence Processes for Selecting Alternative Investments and their Respective Managers."

Wachtell, Lipton, Rosen & Katz LLP
New York, NY (212-403-1000)

ISS Publishes Guidance on Director Compensation (and Other Qualification) Bylaws (January 16, 2014)

A discussion of a new ISS policy position that appears designed to chill board efforts to protect against "golden leash" incentive bonus schemes. Such arrangements have been used by activist hedge funds to recruit director candidates to stand for election in support of whatever business strategy the fund seeks to impose on a company.

Weil Gotshal & Manges, LLP
New York, NY (213-310-8000)

Dispelling the Myths of Side A Directors and Officers Insurance (January 22, 2014)

A discussion of "Side A" D&O insurance to demystify it for directors and companies. The memorandum discusses various Side A products, how much companies should buy, and other issues.

INSIDE THE SEC

Highlights from the San Diego Securities Regulation Institute

By James Moloney and Michael Titera

The 41st Annual Securities Regulation Institute (Institute), sponsored by Northwestern University School of Law, was held January 27th through January 29th, 2014, in Coronado, California. The panels at the Institute covered a number of topics, including the Jumpstart Our Business Startups Act of 2012 (JOBS Act) developments, Securities and Exchange Commission (SEC) disclosure review and rulemaking initiatives, SEC enforcement and criminal investigations, shareholder activism and corporate governance, and mergers and acquisitions developments. Speakers and panelists at the Institute included senior SEC staff, including SEC Chair Mary Jo White, former Delaware Supreme Court Justice Myron T. Steele, and practitioners.

Keynote Address

Chair White's address touched on the SEC's technology initiatives, current rulemakings, and enforcement priorities, among other topics. She highlighted two new tools the SEC is using to keep pace with evolving technology. First, the new National Exam Analytics Tool (NEAT) allows examiners to access and systematically analyze massive amounts of trading data quickly to identify signs of insider trading, front running, window dressing, improper allocations of investment opportunities, and other misconduct. Second, the Market Information Data Analytics System (MIDAS) enables the SEC to collect and sift through tremendous amounts of trading data across markets "instantaneously."[1]

Regarding disclosure reform and the review of Regulation S-K mandated by the JOBS Act, Chair White made clear that she intends to have the SEC conduct a thoughtful and comprehensive review of the rules that goes beyond simply identifying particular requirements that can be eliminated or modified. She stated: "I believe we should rethink not only the type of information we ask companies to disclose, but also how that information is presented, where and how that information is disclosed, and how we can take advantage of technology to facilitate investors' access to information and make it more meaningful to them." This was a theme addressed throughout the conference by many SEC officials. Chair White indicated that she has asked the staff to begin an active review of the SEC's disclosure rules; however, given the breadth of the undertaking, it is unclear when these reforms may be completed.

Chair White also indicated that we will see more SEC cases involving admissions in 2014, noting that the parameters of the types of cases in which the SEC will insist on getting admissions of fault or wrongdoing "will continue to evolve and be subject to further articulation."

JOBS Act—IPO Developments

The first panel discussed IPOs and other registered offerings, with a focus on the impact of the JOBS Act, which was an area of emphasis for panels throughout the Institute. Keith F. Higgins, Director of the SEC's Division of Corporation Finance, noted that the provisions permitting confidential submission of IPO draft registration statements have been the most well received

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aspect of the JOBS Act. Since the JOBS Act was enacted on April 5, 2012, the SEC has received over 400 confidential submissions. Panelists discussed the "shadow pipeline" that has emerged as a result of confidentially submitted draft registration statements and how that has limited visibility into the IPO market. Mr. Higgins also indicated that some companies have taken advantage of the "test the waters" provisions of the JOBS Act. In such cases, the SEC staff has asked to see companies' "test the waters" materials to confirm that they are consistent with the companies' filings.

The panelists discussed various hypothetical situations involving gun-jumping, testing the waters, integration, disclosure policies, and governance and liquidity considerations. With respect to gun-jumping, the panelists generally expressed the view that a general solicitation for a private placement could cause gun-jumping issues if a company does an IPO too close to the general solicitation. With respect to testing the waters, David J. Chen, Managing Director at Morgan Stanley, noted that the provision has not proven to be a particularly useful means of gauging interest in a potential offering or valuing that offering. Moreover, the panelists indicated that many integration issues raised by the JOBS Act remain unsettled.

The discussion of governance and liquidity considerations in IPOs revolved around the potential importance of implementing anti-takeover measures in a company's early years, particularly a dual-class stock structure. Mr. Chen noted that for very strong companies, investment bankers may be able to sustain a dual-class structure in an IPO; however, companies often conclude that it is not worth the time it takes to explain at a roadshow meeting.

Mr. Higgins discussed areas that the SEC continues to focus on when reviewing registration statements. In particular, he indicated that the SEC looks closely at how companies tie the metrics found in their prospectuses to revenue growth and profitability. Mr. Higgins expressed some skepticism about the usefulness of case studies, market statistics, and comparisons in registration statements, noting that these often are not the subject of sufficient diligence. He also indicated that the SEC does not want to see exhaustive detail about valuation methodologies in companies' stock compensation disclosures, as this information tends not to be meaningful to investors in an IPO. While companies need to perform the detailed analyses to arrive at the valuations, they do not need to include their analyses in the filings.

JOBS Act—Private Company Developments

A later panel focused on private company JOBS Act developments. Jonathan A. Ingram, Acting Chief Counsel of the Division of Corporation Finance, began the panel with a discussion of the revisions to Rule 506 under the Securities Act of 1933, focusing on the "bad actor" disqualification provisions in Rule 506(d). He drew attention to two recent Compliance and Disclosure Interpretations (C&DIs) where the SEC addressed questions regarding persons covered under the provisions. Instead of interpreting the term "affiliated issuer" broadly, the SEC chose to interpret it to mean only a co-issuer.[2] The SEC also clarified that the term "beneficial owner" in Rule 506(d) is interpreted the same way as under Exchange Act Rule 13d-3.[3] Stanley Keller of Edwards Wildman Palmer LLP recommended that law firms revisit their accredited investor questionnaires in light of the SEC's new guidance.

The panelists discussed the new Rule 506(c) provisions, which require an issuer to take "reasonable steps" to verify that purchasers are accredited investors. Mr. Ingram indicated that the verification was intended to be a "principles-based" determination, with the four non-exclusive methods listed in Rule 506(c)(2)(ii)(A)-(B) to be used as safe-harbors in situations where there are not sufficient principles-based factors to make the determination. He expressed surprise that practitioners seem to take the opposite view, relying on the non-exclusive methods in the first instance and viewing the principles-based determination as a safe-harbor in the event none of the non-exclusive methods are met. Multiple panelists expressed their views as to why practitioners have preferred to use one of the four non-exclusive methods as opposed to making the principles-based determination the SEC had intended, with one panelist noting practitioners' apprehension about issuing "no registration" opinions that rely on the practitioners' own determination of whether "reasonable steps" were taken to verify investors accredit investor status. Mr. Keller encouraged practitioners to help develop new practices in this area by making their own principles-based determinations of whether reasonable steps were taken instead of relying solely on the safe-harbors provided by the SEC.

Alan L. Beller of Cleary Gottlieb Steen & Hamilton LLP led a discussion of the changed landscape for unregistered offerings. He discussed factors to consider when counseling clients regarding the use of Rule 506(b) and Rule 506(c) offerings. He recommended that if a company is not sure whether it would prefer the general solicitation aspect of a Rule 506(c) offering or the ability of a Rule 506(b) offering to include up to 35 non-accredited investors, that the company start with a Rule 506(b) offering only to verified accredited investors and without any general solicitation. If the company later decides that it needs to include non-accredited investors, it can continue on the Rule 506(b) path and continue to refrain from general solicitation. However, if the company decides that it would like to engage in general solicitation, it can amend its Form D and switch over to a Rule 506(c) offering and continue accepting only verified accredited investors.

Mr. Ingram discussed the additional revisions to Rule 506 that the SEC proposed in July 2013, which would, among other things, require the advance filing of Form D for Rule 506(c) offerings, require the filing of a Form D closing amendment for Rule 506 offerings, and amend the content requirements of Form D.[4] Mr. Ingram noted that the SEC has received over 400 comments on the proposal, most of which express opposition to the proposed revisions. Mr. Keller predicted that none of the revisions will be adopted in the form proposed.

The panel also discussed the SEC's proposal on crowdfunding.[5] Annemarie Tierney, Executive Vice President—Legal, General Counsel and Corporate Secretary of SecondMarket, Inc., indicated that while crowdfunding is an appealing idea, the structure imposed on it by Congress and the SEC may make it unworkable. Another panelist noted that there is a negative perception of crowdfunding in the venture capital community due to its potential to significantly increase the number and diversity of shareholders in companies that use crowdfunding.

The panel then covered the SEC's proposed amendments to Regulation A, which were mandated by the JOBS Act (which the SEC and others referred to as Reg A+).[6] The proposal would build upon Regulation A, which is an existing exemption from registration for small offerings of securities up to $5 million within a 12-month period, and would enable companies to offer and sell up to $50 million of securities within a 12-month period. The panelists agreed that Reg A+ has the potential to be much more relevant than current Regulation A and that the ultimate utility of Reg A+ will depend, in large part, on whether the SEC will permit secondary trading of securities sold in Reg A+ offerings in the future.

The panelists then discussed the impact of the JOBS Act amendments to the Exchange Act Section 12(g) reporting thresholds. Mr. Beller noted that both for companies that plan to go public at some point in the future and for companies that plan to quasi-permanently stay out of the public reporting regime (so called "quasi-public" companies), planning is key to avoiding inadvertently triggering the reporting thresholds. He discussed (1) adding provisions to a company's charter and bylaws to permit the company to determine how many shareholders it has at any given point and whether those shareholders are accredited, and (2) building in enforcement mechanisms such as rights of first refusal and mandatory puts to stay below the thresholds.

SEC Disclosure Review and Rulemaking

Current and former senior SEC officials discussed various disclosure and rulemaking issues on several panels during the Institute. On one panel, Mark Kronforst, Associate Director and Chief Accountant at the Division of Corporation Finance, described key areas of SEC staff focus for reviews in 2014. He indicated that the staff is taking a close look at companies' use of metrics in their filings, noting that while the SEC rarely asks companies to take metrics out, it may ask companies to clarify their explanations and provide additional context for the metrics. He also explained that even though non-GAAP financial measures are not the highest priority for the SEC staff right now, comments are still issued when warranted, such as when the adjustments used are not labeled clearly (a current focus) or when the GAAP figure is not given equal prominence (a focus last year). Mr. Kronforst also explained that the SEC is paying close attention to the headlines regarding cybersecurity breaches and comparing any incidents to companies' disclosures to make sure companies are complying with the Division of Corporation Finance's 2011 cybersecurity guidance.[7]

Meredith B. Cross, former Director of the Division of Corporation Finance, discussed a number of key points to keep in mind when thinking about disclosure and social media. She pointed out that the SEC's recent report regarding whether the CEO of Netflix, Inc. violated Regulation FD by posting information on his personal Facebook account did not change any of the rules applicable to disclosure through social media.[8] The report simply clarified the existing rules set forth in the SEC's 2008 Guidance, which explains that for purposes of complying with Regulation FD, a company makes public disclosure when it distributes information "through a recognized channel of distribution."[9]

Ms. Cross pointed out that while there are no new compensation and governance disclosure rules coming into effect this proxy season, we are seeing companies revise and supplement their proxy disclosures based on pressure from large shareholders and proxy advisory firms.

The panel also addressed various areas of rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that have not been enacted, including the disclosure requirements related to pay versus performance, hedging policies, clawback policies and internal pay ratios. Panelists noted that in some of these areas companies are getting ahead of the requirements by including related disclosures in their proxies. Companies generally have not taken this approach with the internal pay ratio disclosure, although some companies are working with their human resources and accounting departments to make sure that they will be able to gather the required information when a final rule is adopted.

The specialized disclosure requirements relating to resource extraction issuers, conflict minerals and Iran sanctions also were mentioned. In discussing the conflict minerals rules, which are currently on appeal before the U.S. Court of Appeals for the District of Columbia Circuit, Ms. Cross indicated that she does not think companies should wait for a court decision, but instead should do the work to comply in the event the rules are upheld.[10]

During a panel composed solely of officials from the Division of Corporation Finance, Mr. Higgins discussed where the SEC stands with respect to its required Dodd-Frank and JOBS Act rulemakings. He expects the internal pay ratio rules to be finalized in 2014, as well as the proposed changes to Regulation D and Form D. He discussed the difficulties the SEC has encountered with the crowdfunding rules (*e.g.*, the entirely new regulatory superstructure required for funding portals) and Reg A+ (*e.g.*, the controversial preemption of state law aspect of the rule). Mr. Higgins also indicated that although Dodd-Frank did not establish a timeline for the rulemakings dealing with pay versus performance, clawback policies and hedging policies, he expects these rules to be proposed in 2014.

During the Division of Corporation Finance panel, Mr. Ingram discussed notable developments in the shareholder proposal season and pointed out that this season has been more litigious than prior ones. He also mentioned the recently issued C&DIs regarding the unbundling of proxy proposals, which clarify that, in the context of charter amendments, the SEC ordinarily would not object to the bundling of any number of immaterial matters with a single material matter.[11] One particularly interesting aspect of the new guidance related to a company's obligation to unbundle a proposal if management "knows or has reason to believe" that a particular amendment included in the proposal is one on which shareholders could reasonably be expected to wish to express a view separate from their views on the other amendments in the proposal.[12] None of the panelists from the SEC provided clarification regarding this aspect of the guidance.

Continuing on a topic raised by Chair White, the Division of Corporation Finance panel discussed "disclosure overload" at length and what the SEC, companies, and practitioners can do to reduce the amount of information included in filings that is not helpful to investors. Mr. Kronforst cautioned against relying heavily on comments received by other companies to decide what information to disclose because not all comments are applicable to all companies, even within the same industry. One panelist indicated that simply because the SEC asks for information supplementally, does not mean it needs to be included in a company's disclosure on a going forward basis. Shelley E. Parratt, Deputy Director of the Division of Corporation Finance, stressed that a company should not blindly leave a disclosure in its filing simply because the SEC asked for it in a prior period.

Enforcement and Criminal Investigations

Robert S. Khuzami, former Director of the SEC's Division of Enforcement, hosted a panel that included Andrew Ceresney, Co-Director of the Division of Enforcement, and Lorin L. Reisner, Chief of the Criminal Division, U.S. Attorney's Office for the Southern District of New York. The panelists discussed the problems associated with the lack of coordination among the various enforcement agencies both domestically and internationally. Mr. Khuzami expressed his belief that everyone agrees that investigations are coordinated better than in the past, but that issues arise when multiple agencies levy their own separate sanctions based upon the same conduct. Mr. Ceresney indicated that the SEC does try to coordinate with the U.S. Attorney's Office in an effort to prevent "double-counting" settlements.

The panel also addressed U.S. District Judge Jed S. Rakoff's recent criticism of government enforcement entities for not prosecuting high-level executives in connection with the financial crisis. The panelists expressed their views on why more cases based on "willful blindness" or "conscious disregard" theories were not warranted. One panelist pointed out that such cases should be brought very carefully given the tendency to water down criminal intent requirements when the underlying behavior was merely negligent.

The panel also discussed deferred prosecution agreements (DPAs). Mr. Ceresney expressed his view that DPAs are an important remedy for the

SEC to use to guard against future violations, but noted that DPAs should not be used to require broad changes to an entire industry. One panelist expressed concern about the lack of judicial oversight of DPAs, recognizing, however, that recently there has been increased judicial oversight of DPAs by agreement of both parties.

In a later panel, Mr. Ceresney identified the SEC's current enforcement priorities. Areas that remain a focus of SEC attention include investment adviser violations, insider trading, Foreign Corrupt Practices Act violations, and financial reporting and audit issues. He pointed out that the Division of Enforcement's new Financial Reporting and Audit Task Force has improved its ability to detect misconduct involving financial reporting and auditing. New areas of emphasis include compliance issues identified by the Office of Compliance Inspections and Examinations, market structure issues involving exchanges and alternative trading systems, microcap fraud, and compliance issues relating to the new rules regarding derivatives, general solicitation, and credit rating agencies.

Shareholder Activism and Corporate Governance

David A. Katz of Wachtell, Lipton, Rosen & Katz led a discussion of shareholder activism and corporate governance trends in 2013. He noted that some prominent activists have made significant money from their investments, which has attracted other less well-known funds to enter this area. Mr. Katz also pointed out that more traditional investors, such as mutual funds, are increasingly calling on activists to target underperforming companies within their portfolios to turn them around. He stressed that activists are not limiting themselves to targeting only small, underperforming companies, but are targeting large, profitable companies as well. Multiple panelists noted that we are increasingly seeing high-quality dissident board candidates being nominated by activists.

The panelists discussed increased company settlements with shareholder activists, which is typically the preferred outcome for both activists and companies. One panelist noted that activists are increasingly seeking more than just one board seat and they are approaching companies with specific plans for extensive business changes.

M&A Trends and Developments

Several panelists noted that while 2013 was a lackluster year in the M&A market generally, it was a relatively strong year for private equity, which accounted for approximately 30 percent of deal volume.

The panel discussed the continued scrutiny investment banking conflicts are receiving from judges and investors. One panelist noted that, while it is true that board members recognize that the inherent conflicts when investment bankers are paid on a contingent fee basis, board members have become increasingly interested in any personal conflicts investment bankers may have, such as ownership positions in relevant companies or prior work experience with relevant companies. The panel also discussed the increasing number of appraisal actions as hedge funds and other investors are engaging in "appraisal arbitrage" by buying shares that are going to be cashed out in a merger.

The panelists further discussed new Delaware General Corporation Law Section 251(h), which is intended to facilitate the use of friendly tender offers.[13] One panelist noted that the new section facilitates leveraged acquisitions by financial buyers by eliminating the potential delay between the offer and the merger closing, which gives financial buyers immediate access to collateral after the tender offer closes.

The panelists also discussed Delaware courts' treatment of non-reliance provisions in private company acquisition agreements, highlighting recent Delaware cases that address this topic.[14]

Under Delaware law, a properly worded non-reliance clause can protect a seller from claims of fraud outside the contract. However, a mere "no other representations" provision or "entire agreement" provision that does not specifically state that the parties disclaim reliance upon extra-contractual statements will not preclude fraud claims.[15]

There also was discussion of Delaware's three-year statute of limitations for contract actions.[16] The panelists noted that claims based on representations in a contract generally cannot be brought after the three-year statute of limitations has passed, even if the contract specifically provides that the representations survive for a longer period. However, Delaware common law provides that the statute of limitations for a contract can be extended from three years to 20 years by making the contract "under seal," which simply involves including specific language to that effect in the contract.[17]

Notes

1. This data and a wide range of related analyses are presented on the SEC's website. Available at *http://www.sec.gov/marketstructure/midas.html*.
2. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules (Interpretation # 260.16) (December 4, 2013), available at *http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm*.
3. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules (Interpretation # 260.29) (January 3, 2014), available at *http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm*.
4. *See* SEC Release No. 33-9416, "Amendments to Regulation D, Form D and Rule 156 under the Securities Act," July 10, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9416.pdf*.
5. *See* SEC Release No. 33-9470, "Crowdfunding," October 23, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9470.pdf.*
6. *See* SEC Release No. 33-9470, "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," December 18, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9497.pdf.*
7. SEC Division of Corporation Finance Disclosure Guidance, Topic No. 2: Cybersecurity (October 13, 2011), available at *www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm*.
8. SEC Release No. 34-69279, "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings," April 2, 2013, available at *http://www.sec.gov/litigation/investreport/34-69279.pdf*.
9. SEC Release No. 34-58288 "Commission Guidance on the Use of Company Web Sites," August 7, 2008, available at *http://www.sec.gov/rules/interp/2008/34-58288.pdf.*
10. The court's decision is expected out before the first reports under the conflict minerals rules are required to be filed on June 2, 2014.
11. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rule 14a-4(a)(3) (Interpretation # 101.01-#101.03) (January 24, 2014), available at *http://www.sec.gov/divisions/corpfin/guidance/14a-interps.htm*.
12. *Id.* at Interpretation #101.02.
13. The provision permits parties to opt in to a "medium form" merger following a tender or exchange offer and eliminate the previously required stockholder vote.
14. The following cases were discussed: *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1035 (Del. Ch. 2006) ("[T]he case law of this court gives effect to non-reliance provisions that disclaim reliance on extra-contractual representations"); *RAA Mgmt., LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107, 119 (Del. 2012) ("The non-reliance and waiver clauses in the NDA preclude the fraud claims asserted by [Buyer] against [Seller]"); *Anvil Holding Corp. v. Iron Acquisition Co.*, 2013 Del. Ch. LEXIS 129 (Del. Ch. May 17, 2013) (holding that the "no other representations" provision and "entire agreement" provision in an agreement "do not state that the parties disclaim reliance upon extra-contractual statements"); *Transdigm Inc. v. Alcoa Global Fasteners, Inc.*, 2013 Del. Ch. LEXIS 137 (Del. Ch. May 29, 2013) (holding that a seller's anti-reliance provisions did not "bar the buyer's claim for fraudulent concealment of material information").
15. *See Anvil Holding Corp.,* 2013 Del. Ch. LEXIS 129 at *27.
16. *See* Del. Code Ann. tit. 10 § 8106.
17. *See Whittington v. Dragon Group, L.L.C.,* 991 A.2d 1, 14 (Del. 2009).

INSIGHTS

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