FROM THE CHAIR
By Joel I. Greenberg

Our Committee’s next meeting will be held at the Broadmoor Hotel in Colorado Springs on Friday, October 12, and Saturday, October 13. We will have subcommittee, task force and working group meetings from Friday morning through early Saturday afternoon. The full Committee meeting will be held Saturday afternoon, starting at 2:00 p.m., and the Committee Forum on Special Purpose Acquisition Companies (SPACs) will follow at 4:00 p.m. The full schedule for these activities appears on page 20 of this issue of Deal Points.

There will be two Committee dinners: Friday evening at the Garden of the Gods Club and Saturday evening at Cheyenne Lodge.

The full Committee meeting will include an update on the state of the M&A and acquisition finance markets presented by Jennifer Muller of Houlihan Lokey Howard & Zukin, which will focus on developments in the two months since her presentation at the Annual Meeting. Rick Climan will then lead a discussion of recent high profile transactions that have been impacted by the market disruption, including Sallie Mae, Home Depot (HD Supply Unit), Genesco, Harmon International and Acxiom, focusing on the specific deal terms affecting the parties’ leverage in a down market. The M&A Jurisprudence Subcommittee will present a discussion of the Second Circuit Court of Appeal’s decision in Merrill Lynch v. Allegheny Energy (described on pages 15-17 of this issue of Deal Points) and the Ninth Circuit Court of Appeal’s “survival” decision in Herring v. Teradyne.

(continued on next page)
We have made arrangements to permit Committee members who cannot attend the meetings in Colorado Springs to listen to the full Committee meeting and Committee Forum by conference telephone. The domestic toll-free dial-in number is (888) 413-1986 and the international dial-in number is +1(212) 271-4742; the passcode for both numbers is 6074298. The lines will be open from the start of the Committee meeting at 2:00 p.m. through the end of the Committee Forum at 5:00 p.m. Colorado Springs is in the Mountain Time Zone, so the call will start at 4:00 p.m. New York time and 1:00 p.m. California time. Materials will be posted on the Committee website.

I look forward to seeing you in Colorado Springs.

**FEATURE ARTICLE**

**INTERNATIONAL CORPORATE COMPLIANCE & DUE DILIGENCE PRIMER**

John W. Brooks

According to the Oxford English Dictionary, a primer is “a small introductory book on any subject.” Why is a primer on International Corporate Compliance necessary? Put simply, it’s because United States businesses are required to comply with U.S. laws and regulations when they’re operating within the United States, and when they’re operating outside the United States they’re required to comply with those same laws, as well as with other multi-jurisdictional laws and with specific foreign laws and regulations. This should not come as news to anyone, but the record shows that it does, and that record has led to criminal and civil penalties for U.S. companies and their officers, directors and employees. This Primer is designed to help United States businesses understand and avoid these dangers.

**PART 1**

**THE INTERNATIONAL CORPORATE COMPLIANCE MATRIX**

**Domestic (United States) Regulatory Issues.** U.S. businesses are required to operate within a complex mosaic of governmental regulations. Many prudent businesses adopt and follow corporate compliance programs and use transactional checklists to avoid running afoul of those regulations in day to day operations, such as the tax, securities or other regulatory aspects of an acquisition, a borrowing, a product sale, a services contract or an export transaction, among others.

**Multi-Jurisdictional (Int’l) Regulatory Issues.** When one of these same U.S. businesses decides to acquire, or “partner with,” a non-U.S. company, either public or private, or to engage in other regulated commercial activities overseas, it is faced with a similar and equally complex mosaic of international governmental regulations. This combination of domestic and multi-jurisdictional regulations creates an international corporate compliance mosaic (ICCM) that, to many U.S. businesses, is either not well known or is poorly understood.

**The Effect on U.S. Companies Operating Internationally.** The first layer of this ICCM is found in the regulations that govern everyday commercial activities of U.S. companies, public or private, either doing business overseas or engaging in conduct that has effects overseas. These regulations include anti-boycott, anti-
bribery, anti-trust, and export control laws, among others.

The second layer of the ICCM dates from the increased emphasis the U.S. government, since 9/11, has placed on ways to combat terrorism, including terrorist financing, money laundering and bioterrorism laws. Washington not only introduced new laws, it increased the enforcement of existing laws related to commerce, banking, trade and investment generally. These laws were, and continue to be, hugely influenced by three on-going Executive Branch balancing acts: first, the government’s stated need to balance desirable international trade promotion with national security-driven trade regulation; second, the government’s attempt to moderate the forces of corporate enterprise with the restraints of appropriate corporate governance; and third, the government’s struggle to balance constitutionally embedded concepts of civil liberty with perceived needs for civil security. These 9/11 issues are relevant to any U.S. company, public or private, engaged in post-9/11 loans, licenses, acquisitions or other commercial transactions, anywhere in the world.

A third layer of the ICCM has been created by (i) the Sarbanes-Oxley Act of 2002 (SOX), passed in response to the disclosure failings of numerous U.S. companies and (ii) the recent proliferation of U.S. and foreign Data Privacy and Security (DP&S) laws designed to protect personal data from unauthorized use. SOX issues are relevant to any U.S. public company engaged in acquisition transactions anywhere in the world, and DP&S issues are relevant to any company, public or private, engaged in acquisition or other inter-entity transactions.

A fourth layer of the ICCM reveals itself when a U.S. business targets a foreign company either with an acquisition or some form of partnering in mind, such as a joint venture, joint product development, strategic alliance, partnership, distributorship, or an agency relationship. In an acquisition context, this layer includes not only successor liability issues, but also compliance with the regulatory regime of the foreign country when the target is expected to remain in existence, and, in a partnering context, this layer is relevant when the laws of a foreign country are chosen to govern the relationship.

Some important concepts relevant to an understanding of the ICCM and some details relevant to establishing an international corporate compliance program are discussed below. In addition, an international corporate compliance ThoughtList is suggested for U.S. businesses that target an overseas company for acquisition or other commercial dealings.

PART 2

UNDERSTANDING THE ICCM

The Principal U.S. Governmental Players. The Departments of Justice, Commerce, State, and Treasury, together with the Securities and Exchange Commission, are involved in administering and enforcing the ICCM, and the activities of the U.S. Department of Homeland Security provide the government with tools to identify violations of the ICCM. Compliance and enforcement vigor by these players is likely to increase if interdepartmental and intergovernmental coordination improves.

U.S. Sentencing Commission Guidelines Manual. The best reason to understand the ICCM is to become able to understand the importance of an effective corporate compliance program, a topic discussed in Part 3. The best evidence of the importance the U.S. government places on the establishment by every US company, public or private, large or small, of an effective corporate compliance program is the U.S. Sentencing Commission Guidelines Manual (Guidelines Manual) as amended in 2005. The Guidelines Manual is where “the rubber meets the road,”
because it sets forth the standards to be used by judges in sentencing companies and their officers, directors and employees for violating the laws comprising the ICCM. These standards include a company’s “culpability score” (§8C2.5 of the Guidelines Manual) in which the existence of an “Effective Compliance and Ethics Program” can lower a violator’s culpability score, and consequently the resulting financial sanctions, by 50-60%. The Guidelines Manual also provides that if an individual within the “high-level personnel of the organization” participated in, condoned, or was willfully ignorant of a violation of a law comprising the ICCM, the organization’s culpability score, and the resulting financial sanctions, can be increased from 10-100%. The United States is in an era of increasing international competition, and given the likelihood of even an inadvertent violation of one of the laws comprising the ICCM, the bottom line benefits of an effective international corporate compliance program are clear.

Meaning of Certain Words. Throughout this Primer, the phrase “U.S. acquiring company” should be understood to mean any U.S. actor that is contemplating acquiring, investing in, partnering with, or creating an agency relationship with, the target. Similarly, the word “target” should be understood to include any entity or person that is to be acquired, invested in, partnered with, or is intended to become the agent of the U.S. acquiring company.

U.S. Export Control Laws

The U.S. Export Control Laws are primarily administered by the Commerce Department’s Bureau of Industry and Security (BIS), by the State Department’s Office of Defense Trade Controls (ODTC), and by the Treasury Department through the OFAC Regs described below, but an array of other agencies have jurisdiction in limited areas. The Export Administration Act of 1979 (Commerce Department) is implemented by the Export Administration Regulations (EAR). The Arms Export Control Act (State Department) is implemented by the International Traffic in Arms Act (ITAR).

The Export Enforcement Act of 2007, introduced in April 2007, proposed, among other things, to increase substantially civil and criminal penalties for export control law violations (corporate criminal penalties up from $50,000 to the greater of $5,000,000 or ten times the value of the exports involved) and to provide enforcement agencies undercover and overseas investigative authority.

The EAR regulates the export of commodities and technical data from the United States and their re-export to third countries. These regulations are intended to prevent the transfer of technologies that could enhance the military potential of other countries, to halt the proliferation of nuclear and chemical weapons and the depletion of scarce resources, and to advance U.S. foreign policy. The BIS is charged with enforcement of the EAR. The BIS classifies commodities and technical data by level of technology, product type, and destination. Depending on these classifications, an export or re-export may be permissible only with specific license authorization or prohibited altogether. A U.S. exporter may be liable for violation of the statute if it exports or attempts to export with “knowledge” or “reason to know” that the exporter has not complied with the statute. The EAR are maintained at the BIS website at www.bxa.gov.

The ITAR prohibits the export of defense articles and services that add to the military potential of other countries and terrorist groups. The prohibited items are specifically identified on the U.S. Munitions List set forth in the (ITAR) administered by the U.S. Department of State, Office of Defense Trade Controls (formerly the Office of Munitions Control). The ITAR controls are of particular concern to companies engaged in
sales of military and defense-related equipment. The law may also prohibit the export of any commodity or product if it has substantial military applicability (over-the-counter software with encryption features, for instance) or has been modified for military purposes. The ITAR are maintained at the ODTC website at www.pmdtc.org.

The U.S. Government expects every U.S. company to know the U.S. Export Control Laws and, of equal importance, to know their customers’ businesses. Because recent enforcement actions have attempted to hold successors responsible for a target’s export control violations even in the context of an asset acquisition, for a U.S. acquiring company, export control-based inquiries should include the following:

► Does the target export products, technology or software, and, if so, has it obtained appropriate licenses for such exports when required, and has it complied with all license conditions, including record-keeping requirements?

► Do the target’s records establish it knows who the end user of its exported item will be and what the end use will be?

► Do any of the target’s products constitute “defense articles,” and, if so, has the target company registered with the ODTC?

► Does the target employ foreign nationals with access to controlled items, technology or software, and, if so, has it obtained “deemed export” licenses for such activities?

**Office of Foreign Assets Control**

Under authority of the International Emergency Economic Powers Act (50 U.S.C. § 1201) and other federal statutes, the president has imposed trade controls on countries that present a threat to U.S. national security or foreign policy. The Office of Foreign Assets Control of the Department of Treasury (OFAC) has primary authority for promulgating and administering regulations implementing these embargoes.

OFAC regulations prohibit a wide range of business activities, such as imports from an embargoed country (e.g., Iran and Iraq) and dealings in property in which an embargoed country has an interest (e.g., Iraq). OFAC Regulations also prohibit U.S. persons from dealings with individuals and entities determined by the U.S. government to be involved in terrorism or terrorism-related activities. Such persons are termed “Specially Designated Nationals” (SDNs), and a regularly updated list of SDNs is maintained at the OFAC website at www.treas.gov/offices/enforcement/ofac.

For a U.S. acquiring company, OFAC-based inquiries should include:

► Screening the individuals and entities with whom they will be dealing in connection with the proposed transaction against the list of SDNs on the OFAC website and maintaining a due diligence record of the results.

► Determining if the target is subject to the OFAC regulations and, if so, determining whether it has had any dealings with SDNs or has exported goods or supplied services to any SDN.

**TO CONSIDER.** Reviewing the target’s written policies and procedures for compliance with the OFAC regulations that every U.S. company with substantial overseas operations, assets or investments should have.

**TO CONSIDER.** Obtaining the Export Control Classification Number (ECCN) for each item produced by the target and analyzing all applicable restrictions on export or re-export to determine whether such restrictions (if properly observed) would adversely affect the target’s sales.
Anti-Boycott Regulations

The Export Administration Act’s anti-boycott provisions (50 U.S.C. App. 2401 (Section 8 of the act)) (AB Regs) prohibit participation by U.S. persons and companies from complying with unsanctioned foreign boycotts against U.S. allies, particularly the Arab League boycott of Israel. This law is administered by the Department of Commerce, Office of Anti-boycott Compliance. Prohibited activities include discriminatory conduct based on sex, religion, race, or national origin; refusal to do business with a boycotted person, entity, or country; furnishing to a foreign government or customer information about one’s business relationships or affiliations with charitable organizations or a person’s race, religion or national origin; and implementing letters of credit containing prohibited conditions (15 C.F.R. 769). U.S. companies are required to file quarterly reports with the Treasury Department listing requests they have received to comply with or support an unsanctioned foreign boycott.

AB Regs are of special concern to companies doing business in the Middle East. Culpability exists if a target engages in the prohibited activities and is shown to have intended to support a boycott. The Department of Commerce shares enforcement jurisdiction with the Department of Justice, which Prosecutes criminal violations, and the Department of Treasury, Internal Revenue Service, which imposers certain reporting requirements on U.S. taxpayers.

If the target does business in, or has assets or investments in, the Middle East or other boycotting countries, AB Regs-based inquiries of a U.S. acquiring company should include the following:

- Has the target adequately trained appropriate employees to identify boycott-related language and, if so, has it properly reported boycott-related requests received from suppliers, customers, business partners or other persons?

TO CONSIDER. Examination of the target’s contracts to determine whether any contain boycott-related language, because compliance with a boycott request or participation in or support of an unsanctioned foreign boycott can lead to loss of a U.S. target’s foreign tax credits, foreign subsidiary deferral benefits, Foreign Sales Corporation benefits, and Interest Charge-Domestic Sales Corporation benefits.

Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act (FCPA), adopted in 1977 and significantly amended in 1998, prohibits bribery of foreign officials. The anti-bribery provisions of the FCPA prohibit any U.S. person or entity from bribing a foreign government official in order to obtain or retain business or secure an improper business advantage. The record keeping provisions of the FCPA require any issuer of publicly traded securities to keep accurate books and records and maintain a system of internal controls to assure accountability for assets.

The Department of Justice (DOJ) administers the anti-bribery provisions of the FCPA, and the Securities and Exchange Commission (SEC) administers the record keeping provisions of the FCPA. The penalties for violations are substantial. Culpability under the act requires “knowledge” on the part of the violator, which includes conscious disregard of known circumstances. The act should be treated with great care and is of particular importance to companies that regularly engage foreign agents. A narrow exception to the FCPA anti-bribery rule permits “facilitating payments” to government employees for routine governmental actions (e.g., obtaining permits, providing telephone or electric
service), but the anti-bribery laws of other countries (to which a U.S. violator may also be subject) do not recognize this exception. Additionally, an affirmative defense exists for payments that are lawful under a foreign country’s written laws or for expenditures associated with product demonstration.

The FCPA has been seen by some as unfairly burdening U.S. companies because it makes competition for international contracts more difficult. Recently, the U.S. Government has attempted to even the playing field by encouraging other countries to enact anti-bribery laws. Two significant foreign laws are the 1999 Convention for Combating Bribery enacted by the Organization for Economic Cooperation and Development (OECD) and the 1996 Inter-American Convention Against Corruption enacted by the Organization of American States (OAS). The Department of Justice regulates relations between the U.S. and other OAS and OECD countries. For a U.S. acquiring company, FCPA-based inquiries should include:

► Determining whether the target engages in business in a country with corruption problems. (Check the Transparency International website at www.transparency.org.)

► Determining which major anti-bribery and anti-corruption laws are applicable to the target and its subsidiaries.

► Reviewing financial accounts to identify large and frequent payments in cash, payments of unusually large commissions, reimbursements of poorly documented expenses, or large and frequent political contributions.

► Interviewing relevant employees regarding possible rumors of unethical or suspicious conduct by a consultant or intermediary for the target or by a government official associated with a particular transaction.

TO CONSIDER. For a target subject to the record keeping requirements of the FCPA, repeating these inquiries with its foreign subsidiaries, because bribery or corrupt activity by a foreign subsidiary can lead to SEC enforcement action against the parent, even if the parent did not know or have reason to know of the activities of its foreign subsidiary. Overseas compliance issues involving U.S. companies’ foreign subsidiaries and branches, salespeople, distributors, suppliers, partners and agents are increasingly the focus of DOJ bribery and SEC record keeping enforcement actions. In three cases in the first quarter of 2007, over $30 million in civil and criminal fines were assessed as a consequence of bribery violations by foreign subsidiaries of U.S. companies.

USA PATRIOT Act

The USA PATRIOT Act (“Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorists” or UPA) became law on October 26, 2001. The UPA attempts to provide the U.S. Government with new tools for combating, among other things, terrorist financing and money laundering. The anti-money laundering (AML) provisions require certain types of companies to establish (i) an anti-money laundering program, (ii) procedures for customer identification and verification, and (iii) suspicious activity reports (SARs). To accomplish this, the UPA amended the Bank Secrecy Act, a federal anti-money laundering statute (BSA), to expand the types of “financial institutions” subject to the BSA. “Financial institutions” now include not only banks, trust companies, saving associations, and credit unions, but also securities broker-dealers, mutual funds, check cashers and currency exchanges, casinos, dealers in precious metals and jewels, insurance companies and others.

If the target is a “financial institution” as defined by the UPA, UPA-based inquiries of a U.S. acquiring company should include:
Determining whether the target has adopted the required AML Compliance Program, has appointed an individual or committee to monitor compliance with the BSA and the UPA, and whether that individual or committee is sufficiently familiar with the BSA and the UPA.

Determining whether the target’s compliance with the BSA and the UPA has been tested by audit and reviewing the results of such audit.

Reviewing the procedures of the target for collecting minimum customer identification, verifying the information before opening new accounts, training employees in customer identification and verification requirements, and maintaining appropriate records.

Confirming that the target has implemented policies and procedures for identifying and reporting suspicious transactions, trained employees to identify suspicious activities, and designated employees as responsible for filing SARs.

TO CONSIDER. Reviewing all SARs filed, and their underlying documentation, to determine the quality of the target’s understanding and implementation of the AML, customer verification and SAR requirements of the BSA and the UPA.

**Bioterrorism Act**

The Bioterrorism Act (BA) was passed by Congress in 2002 and is administered by the Bureau of Customs and Border Protection (CBP) and the Food and Drug Administration (FDA). Almost 20% of all imports into the U.S. are food and food products. FDA rules now require prior notice of food imports to the United States and registration of both foreign and domestic food facilities in an attempt to prevent the introduction of biological agents into the U.S. food supply. In a parallel effort, the CBP has implemented a Container Security Initiative (CSI) to help prevent global containerized cargo from being exploited by terrorists. These rules will carry record keeping requirements and may result in import delays for, or seizures of, food shipments for companies that have not registered or pre-notified as required. A secondary effect could result from the possibility of the U.S. government linking security cooperation with trade initiatives and granting economic rewards to countries that actively support BA supply chain security regulations to the detriment of those that don’t. For example, a new “free trade” agreement with Country A (that supports U.S. food safety regulations) could disadvantage a target with operations or suppliers in Country B that (for whatever reason) chooses to withhold such support.

The BA’s possible effects on the activities of the target are indirect and relate to whether shippers in the countries from which the target (or its affiliates or suppliers) exports to the U.S. have made the technological investments in shipping safety to comply with the food product security standards of the BA. If a country from which such shipper operates does not actively support the U.S. government’s anti-terrorism measures, it may impair its chances of signing a free trade agreement with the U.S., thereby marginally disadvantaging the target.

If the target has overseas exporting subsidiaries or suppliers (whether or not in the food products business), BA-based inquiries of a U.S. public or private acquiring company should include:

- Determining whether the target, or any of its U.S. or foreign subsidiaries, manufactures, processes, packs, or holds food for human or animal consumption in the U.S., and, if so, whether its relevant physical facilities were registered with the FDA by December 12, 2003.

- Determining whether the target and its domestic or foreign subsidiaries have appropriate
procedures in place to give required prior notification to the FDA of any food imports into the U.S. and whether their foreign food exporters/shippers have adopted CSI-mandated pre-screening procedures and electronically-sealed “smart” containers for food products in order to avoid import delays or seizures on arrival in the U.S.

► Determining whether the shippers in the countries from which the target (or its subsidiaries and suppliers) exports to the U.S. are likely to be willing to make (or obtain their government’s support to make) the technology investments needed to comply with U.S. standards on food product security.

► Inquiring as to the status of proposed favorable trade initiatives with countries that actively support the U.S. government’s anti-terrorism campaigns and the denial of such initiatives to those that don’t.

TO CONSIDER. Analyzing the financial effect on the target of compliance with the food import related sections of the BA, with regard to the likelihood that exports of goods other than food products from countries less inclined to support U.S. anti-terrorism regulations may be marginally disadvantaged if free-trade initiatives are not offered to those countries.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 (SOX) established a Public Company Accounting Oversight Board to oversee the audit of public companies (domestic or foreign) that are subject to the U.S. securities laws. SOX introduced significant changes in corporate financial practice and governance regulation, including standards for auditor independence, corporate responsibility and financial disclosure. Revisions to Section 404 (auditing of internal control mechanisms) were adopted in June 2007.

SOX was passed by Congress in 2002, and the bulk of its regulations have been issued by and are enforced by the U.S. Securities and Exchange Commission. The stock exchanges and NASDAQ have also issued SOX-related corporate governance proposals binding on their listed companies. Although the lion’s share of the financial press news describing these regulations and proposals has focused on governance and disclosure issues, SOX regulations will have a major effect on the way public company acquisitions now will be investigated and how they will be documented. The reason for this, of course, is that executives, accountants and lawyers involved in those acquisitions will now, potentially, be held responsible and accountable for their actions, with possible consequences including forfeiture by the U.S. acquiring company’s CEO and CFO of their performance-based compensation or stock sale gains if a target’s misconduct causes a post-closing restatement of the combined financial statements. Additionally, because the other rules and regulations described in this Primer impose compliance responsibilities on companies, a compliance failure may represent an event that should be reported to the corporate audit committee or outside auditors. For those reasons, among many others, a U.S. public acquiring company’s SOX-based inquiries should include:

► Determining the target’s true financial condition, results of operation and prospects, regardless of their GAAP treatment, and, if the target happens to be in the same business segment as yours, rationalizing any of its variant accounting policies with your own prior to closing.

► Determining the disclosure controls and procedures, if any, in place at the target, so that new procedures can be adopted, or necessary changes made in old procedures, to integrate the target’s controls and procedures with your own at closing or shortly afterward, thereby allowing required CEO and CFO certifications to be made.
 Assessing the strength of the corporate governance policies and international trade compliance practices of the target and determining whether those policies and practices are appropriate and in fact being implemented.

TO CONSIDER. Reviewing copies of the target’s principles of corporate governance, charters and minutes of audit, compensation and nominating/corporate governance committees, together with codes of compliance/conduct, board evaluations, and records of compliance with import, export and trade regulations, corporate governance ratings from third-party services, and any whistle-blower complaints to help assure non-violation of the SOX-related listing standards of exchanges and NASDAQ.

Data Privacy and Security Laws

Over the past several decades, the United States has adopted multiple data privacy and security (DP&S) laws at federal, state and local levels. These laws sometimes overlap each other and sometimes duplicate one another. Some of them relate only to specific kinds of information – medical, financial, employment and the like. Overseas, scores of foreign countries have adopted similar data protection laws, often with vigorous but dissimilar privacy protection and data security provisions. SOX requires U.S. companies to attest to adequate control of data in their possession. Loss of customer data may involve SOX issues and trigger reporting under SOX Section 307. In addition, if a U.S. company acquires and uses information obtained from its foreign subsidiaries or other business partners, it must do so not only in compliance with U.S. laws, but also in a fashion that complies with the foreign DP&S laws applicable to those foreign partners.

Because DP&S law violations can result in consequences ranging from civil fines to class actions to jail terms, DP&S-based inquiries for a U.S. acquiring company should include:

 Identification whether the target owns databases with information about its employees, customers and prospects; whether it has a privacy policy and procedures; what information security controls it has established; and what DP&S laws govern the activities of the target.

Assessing whether appropriate records have been maintained by the target with respect to its collection and handling of personal data.

Determining whether there are any restrictions on transferring target’s databases to, or sharing them with, another party, and what, if anything, must be done before completion of the proposed transaction to comply with the DP&S laws applicable to the target.

TO CONSIDER. Reviewing the target’s privacy policies and security procedures and comparing them to public or website statements made by the target concerning those policies and procedures; obtaining the results of any internal or external privacy/security audits of those DP&S policies and procedures; comparing those policies and procedures with the laws applicable to target relating to collection, processing, storage and transfer of personal data, and either curing deficiencies or adjusting the economics of the proposed transaction to provide for reasonably anticipated DP&S liabilities.

The European Union

The European Union (EU) dates to the Treaty of Rome in 1957 and now consists of 27 Member States comprising almost 500 million people bound together by a supranational legal framework. EU law consists of the Treaty of Rome and the Maastricht Treaty of 1992, EU Regulations, and EU Directives. Regulations cover all EU Member States and are self-executing. Directives require each Member State to adopt its own regulation on the specified subject matter of the Directive. For cases in
which EU law conflicts with Member State law, EU law is paramount.

EU Directives cover subject matters ranging from equal opportunity in employment to general product safety, and from enforcement of intellectual property rights to privacy and data protection. The failure to comply with applicable EU law can lead to transactional delays and possible economic penalties.

**Antitrust Issues**

An acquisition may implicate U.S. antitrust laws by reason of the target’s foreign operations in at least two ways: (i) the combination of the U.S. acquiring company’s and the target’s activities in certain lines of business of U.S. foreign commerce may result in a prohibited degree of concentration; and (ii) the foreign commerce activities of the target itself, generally in concert with foreign trading partners, may have anticompetitive results for U.S. businesses. There are numerous ways in which the combined activities of the U.S. acquiring company, the target, and the target’s affiliates can, under the increased regulatory scrutiny that often accompanies an acquisitive transaction, result in transactional delays and possible unintended changes in the structure of the acquisition.

**Foreign Operations Issues**

The target’s compliance with foreign laws and the post-acquisition effects of the target’s foreign operations must be investigated with the assistance of appropriate foreign counsel. Non-compliance by the target with its own domestic laws is a frequently under-investigated aspect of acquisitive transactions.

**PART 3**

**ESTABLISHING AN EFFECTIVE COMPLIANCE AND ETHICS PROGRAM**

**The Program**

For an effective compliance and ethics program (Program), an organization must (i) exercise due diligence to prevent and detect criminal conduct and (ii) otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law. The U.S. Sentencing Commission Guidelines Manual provides that items (i) and (ii) above require the organization at a minimum to establish standards and procedures to prevent and detect criminal conduct. This in turn requires:

► that the company’s board of directors be knowledgeable about the content and operation of the Program and exercise reasonable oversight with respect to its implementation and effectiveness;

► that high-level personnel in the company ensure that the company has an effective Program and that specific individual(s) are assigned overall responsibility for the Program;

► that specific individual(s) are delegated day-to-day operational responsibility for the Program and that they report periodically to high-level personnel, and, as appropriate, to the company’s board of directors on the effectiveness of the Program; and

► that the company take reasonable steps:

1. to communicate periodically, and in a practical manner, its standards and procedures and other aspects of the Program to its officers, directors, employees, and, as appropriate, its agents;
2. to ensure that its Program is followed, including monitoring and auditing to detect criminal conduct;

3. to evaluate the Program periodically; and

4. to have and publicize a system, that may include mechanisms for anonymity or confidentiality, in which the company’s employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

Finally, the Guidelines Manual requires the Program to be promoted and enforced consistently throughout the company through appropriate (i) incentives to perform in accordance with the Program and (ii) disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to detect criminal conduct, and after any criminal conduct has been detected, to respond appropriately to it and to prevent any further such conduct, including making any necessary changes in the Program.

**Establishing a Program**

There are numerous organizations in the business of assisting U.S. companies and their overseas subsidiaries establish and implement comprehensive, culturally appropriate international corporate compliance programs. Many of these organizations can be found at the website of the Ethics Officers Association at [www.eoa.org](http://www.eoa.org).

**CONCLUSION**

U.S. businesses operate within a layered mosaic of governmental regulations, some of which are described above. As these regulations grow in complexity, it becomes increasingly obvious that the U.S. government’s attempt to balance policy considerations in the areas of (i) trade promotion and regulation, (ii) corporate enterprise and governance, and (iii) civil liberty and security can result in a zero sum game in which a governmental policy gain becomes a business enterprise’s expense or loss. Zero sum games imply winners and losers. Perhaps this Primer will help U.S. companies come out winners more often than losers in their domestic and international acquisition transactions.

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**TASK FORCE REPORTS**

**Task Force on Acquisitions of Public Companies**

Our meeting in San Francisco in August was a great success! We had a wonderful dinner Friday evening with Task Force members at the Boulevard, a San Francisco institution, thanks to Ed Deibert and Dick Canady. On Saturday we discussed Section 1 of the Model Agreement and the Exchange Ratio Article, courtesy of Hal Leibowitz, Jay Bothwick and Yvette Austin Smith.

Our meeting took place in the absolutely stunning Crown Room at the Fairmont Hotel. Mouth dropping views did not however stop a lively discussion about what happens to the stock being issued in a stock deal – and, in particular, whether the Exchange Agent treats the shares as outstanding at the closing or only upon receipt of completed letters of transmittal. For those who missed this tour de force by Henry Lesser, David Katz, and others, we can only say – stay tuned! The Model Agreement will reflect our latest views. We discussed the Exchange Ratio Article and the fact pattern as well.

At the Editorial Board meeting in San Francisco, Leigh Walton discussed the status of the representations and warranties. We also talked about key issues for the introduction.
At the upcoming Colorado Springs meeting we hope to discuss the voting agreement, the termination sections and the conditions sections. We hope to see you all there. We will have a call in number circulated with the materials for the meeting.

Our Wilmington meeting dates have been set for February 28 - March 1, 2008. If you are active in the Task Force, please mark your calendar and plan to attend this annual pilgrimage to the epicenter of the M&A world – Wilmington Delaware, where we get the chance to meet with the Delaware judiciary about the Delaware law issues impacting M&A transactions.

Diane Holt Frankle
Stephen H. Knee
Co-Chairs

Task Force on Joint Ventures

A small group of Task Force members has been assembled, under the leadership of Alison Youngman, to “internationalize” the Model Joint Venture Agreement. A questionnaire has been sent out to counsel in twenty countries and we have received about 90% of the responses. We are in the process of following up on the remaining responses. Thanks to all of the members of our Committee who are participating in this project.

Thomas B. Hyman, Jr.
Alison J. Youngman
Co-Chairs

Task Force on the Model Stock Purchase Agreement

The Editorial Committee of our Task Force continues to focus its attention on the Commentary for the Revised Model Stock Purchase Agreement. The Committee is now coordinating its efforts on the Commentary with the Judicial Interpretations Working Group of the M&A Jurisprudence Subcommittee and drafting assignments were made at the last meeting. Bill Payne is working on the new text revisions for Article 2 Commentary. Those revisions will be reviewed in depth at our next meeting in Colorado Springs.

We look forward to seeing you in Colorado Springs.

Robert T. Harper
Chair

SUBCOMMITTEE REPORTS

International M&A Subcommittee

The International M&A Subcommittee met on Sunday, August 12, in connection with the ABA’s Annual Meeting in San Francisco.

The meeting began with an informative presentation on M&A transactions in Argentina by Alfredo Rovira. Katrien Vorlat and Guy Harles then discussed their progress on the post-closing dispute resolution project that the Subcommittee had decided to pursue at prior meetings. They presented a draft of a questionnaire that would be circulated to practitioners in a broad range of representative jurisdictions around the world eliciting their views on the types of post-closing dispute resolution mechanisms used in their jurisdictions and the relative merits and frequency of the use of alternative dispute resolution mechanisms. After discussion of the draft, it was decided that Katrien and Guy would move forward with sending out the questionnaire. Katrien raised the question whether the intended work product of this project would include written material to be published in hard copy by the ABA. After discussion, it was the sense of the meeting that such published materials should be at least one of the objectives for this project.
Freek Jonkhart then led a panel discussion of Subcommittee members on the subject of the impact of shareholder activism on M&A from an international perspective. Panel members provided informative discussions of this subject from the perspectives of their respective jurisdictions. In addition to Freek, the panel included Guy Harles, Michael Hollingsworth, Franziska Ruf, Alfredo Rovira, Rick Silberstein and Christiaan de Brauw.

The meeting concluded with our customary open floor general discussion by Subcommittee members regarding legal developments in their jurisdictions relevant to M&A practice and particular issues they have recently encountered. Among other topics, the members discussed the current, and possible longer term, effects in their jurisdictions of the recent turmoil in the credit markets.

Our next meeting will be held in connection with our Committee’s stand-alone meeting at the Broadmoor Hotel in Colorado Springs. Our meeting is scheduled for Saturday, October 13, from 8:00 a.m. to 10:30 a.m.

Daniel Rosenberg  
James R. Walther  
Co-Chairs

**Membership Subcommittee**

As of September 28, 2007, our Committee had over 2,425 members representing 41 countries. We have over 240 in-house counsel members and over 190 associate (non-lawyer) members. Currently, the M&A Market Trends Subcommittee is our largest subcommittee with over 685 members. Given our current growth rate, we may soon become the largest committee in the Business Law Section.

Hendrik Jordaan  
Chair

**M&A Jurisprudence Subcommittee**

The M&A Jurisprudence Subcommittee has two working groups. The Annual Survey Working Group identifies and reports to the Committee on recent decisions of importance in the M&A area, and prepares the Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions, which is published annually in *The Business Lawyer*. The Judicial Interpretations Working Group examines judicial interpretations of specific provisions of acquisition agreements and ancillary documents, looking not only for recent M&A cases of special interest, but also examining the entire body of case law on the specified type of provision. The Annual Survey Working Group will meet in the Broadmoor Hotel, on Friday, October 12, from 12:30 p.m. until 2:00 p.m. The Judicial Interpretations Working Group will meet immediately thereafter, from 2:00 p.m. until 4:30 p.m.

**Annual Survey Working Group**

The fifth Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions was published in the February 2007 issue of *The Business Lawyer*. Our working group has been collecting and summarizing 2007 cases for inclusion in our 2007 annual survey. We thank all Committee members who have suggested cases. We will discuss the case summaries in Colorado Springs and consider several additional cases for possible inclusion in the 2007 survey. We are asking all members of the Committee to send us significant judicial decisions for possible inclusion in the survey. Submissions can be sent by email either to Scott Whittaker at swhittaker@stonepigman.com or to Jon Hirschoff at jhirshoff@fdh.com. You may fax cases to Scott at (504) 596-0836 or to Jon at (203) 325-5001. Please state in your email or on the fax cover sheet why you believe the case merits inclusion in the survey.
The first criterion for inclusion is that the decision must involve a merger, an equity sale of a controlling interest, a sale of all or substantially all assets, a sale of a subsidiary or division, or a recapitalization resulting in a change of control. The second criterion is that the decision must (i) interpret or apply the provisions of an acquisition agreement or an agreement preliminary to an acquisition agreement (e.g., a letter of intent, confidentiality agreement or standstill agreement), (ii) interpret or apply a state statute that governs one of the constituent entities (e.g., the Delaware General Corporation Law or the Louisiana Limited Liability Company Law), (iii) pertain to a successor liability issue, or (iv) decide a breach of fiduciary duty claim. We are currently excluding cases dealing with federal law, securities law, tax law, and antitrust law. But if you feel a case dealing with an M&A transaction is particularly significant please send it, even if it does not meet the foregoing criteria.

**Decision to be Discussed at the Colorado Springs Committee Meeting**


Allegheny’s claims arose out of its purchase from Merrill Lynch of Global Energy Markets (“GEM”), a commodities trading business. The claims were asserted as counterclaims in an action brought by Merrill Lynch based on an alleged breach by Allegheny of the Asset Contribution and Purchase Agreement (the “Agreement”) relating to the sale of GEM.

In the Agreement, Merrill Lynch made the following representations:

Section 3.12(b) stated that the “Business Selected Data” was prepared in good faith by management based upon the financial records of the business.

Section 3.12(c) stated that “the books of account and other financial records of [GEM] (i) are in all material respects true, complete and correct, and do not contain or reflect any material inaccuracies or discrepancies and (ii) have been maintained in accordance with [Merrill Lynch’s] business and accounting practices.”

Section 3.16 stated that the information provided to Allegheny “in the aggregate, includes all information known to the Sellers which, in their reasonable judgment exercised in good faith, is appropriate for the Purchasers to evaluate [GEM’s] trading positions and trading operations.”

Merrill Lynch prepared and delivered to Allegheny financial data on GEM’s performance and profitability in September and October 2000. The October financial summaries showed revenues of $32 million attributable to the “Williams Contract”, under which GEM had options to buy electricity. In early January, a few days before the scheduled signing of the Agreement, Merrill Lynch realized that the September and October summaries varied significantly from Merrill Lynch’s books, and prepared a January 2001 summary, which according to the Court of Appeals opinion did not reflect $28 million in losses incurred on the Williams Contract. Allegheny was apparently
informed that the updated January report should be substituted for the September and October summaries. Allegheny asserted that it “rejected the new financials and insisted that the deal proceed on the basis of the September and October reports.”

GEM’s chief executive officer, Dan Gordon, knowingly provided inaccurate information in the September and October financial summaries. After the closing, it was learned that he had embezzled $43 million from Merrill Lynch, although there was no direct evidence that other officers of Merrill Lynch knew of the embezzlement.

In the appeal, Merrill Lynch contended that Allegheny could not assert both fraud and breach of warranty counterclaims. The Court of Appeals disagreed, holding that under New York law, Allegheny’s claim that it was fraudulently induced to enter into the Agreement was separate and distinct from its breach of contract claim.

With respect to the fraud counterclaim, Judge Baer in the District Court opinion concluded that Allegheny did not justifiably rely on any representations or omissions by Merrill Lynch, citing Grumman Allied Industries, Inc. v. Rohr Industries, Inc., 748 F.2d 729, 737 (2d Cir. 1984), for the proposition that “where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance.” In reversing Judge Baer’s dismissal of the fraud counterclaim, the Court of Appeals said: “The district court found that because Allegheny could have discovered the [truth] . . . . had it pursued its due diligence ‘with a little more pizzazz’, its fraud counterclaim failed to satisfy the justifiable reliance prong. It charged Allegheny with the means and responsibility to discover, for example, Gordon’s embezzlement, notwithstanding Merrill Lynch’s claim that its own officials were unaware of the embezzlement until after the sale of GEM.”

The Court of Appeals held that Allegheny was entitled to rely upon the representations in Sections 3.12(b), 3.12(c) and 3.16 of the Agreement “without further investigation or sleuthing.” It quoted Judge Learned Hand’s statement, in Metropolitan Coal Co. v. Howard, 155 F.2d 780, 784 (2d Cir. 1946), that “[a] warranty . . . . is intended precisely to relieve the promisee of any duty to ascertain the fact for himself.” Judge Cardamone’s opinion refers as well to Judge Friendly’s opinion in Mallis v. Bankers Trust Co., 615 F.2d 68, 80-81 (2d Cir. 1980), to the effect that New York follows a two-tier standard in assessing the duty of the party claiming fraud, according to whether the misrepresentations relate to matters peculiarly within the other party’s knowledge.

Although it thus held that Judge Baer had held defendant to too stringent a standard of reliance, the Court of Appeals stated (with reference to the fraud counterclaim) that “on remand Allegheny must offer proof that its reliance on the alleged misrepresentations was not so utterly unreasonable, foolish or knowingly blind as to compel the conclusion that whatever injury it suffered was its own responsibility.”

The District Court also held, with respect to both Allegheny’s contract and fraud claims, that GEM’s positive performance in the year following the sale, together with the lack of any causal link between GEM’s ultimate failure and Merrill Lynch’s misrepresentations, meant that Allegheny had not suffered damages caused by the alleged misrepresentations and breaches of warranties. The Court of Appeals held that Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005), governing fraud claims in the securities context, and relied upon by the District Court, is not applicable to the sale of a business under New York law. In the securities context, an inflated purchase payment made for a “misrepresented stock” is offset by ownership of a share that at that instant represents equivalent value. The Court
assumed that in agreeing on a purchase price, the parties placed value on intrinsic qualities such as key personnel and financial performance. If Merrill Lynch fraudulently misrepresented those qualities, Allegheny “may show that it has acquired an asset at a price that exceeded its true value.” Thus, if on remand the District Court finds the fraud claim valid, damages should be awarded to the extent that the purchase price overstated GEM’s value on the date of sale as a result of the misrepresentations.

With respect to the measure of damages on the contract claim, the Court of Appeals stated that its conclusion that Dura does not govern the fraud counterclaim applies a fortiori to the breach of warranty counterclaim. Citing CBS, Inc. v. Ziff-Davis Publ’g Co., 75 NY2d 496, 503, 553 N.E.2d 997 (N.Y. 1990), the Court held that under New York law, an express warranty is part and parcel of the contract and an action for its breach is grounded in contract. A party injured by a breach “is entitled to be placed in the position it would have occupied had the contract been fulfilled according to its terms.” Thus Allegheny is entitled to the benefit of its bargain, “measured as the difference between the value of GEM as warranted by Merrill Lynch and its true value at the time of the transaction.”

Finally, with regard to the District Court’s conclusion that Allegheny would not have insisted on a lower price had it known all the facts, from which the District Court inferred that Allegheny did not rely on the representations in agreeing to close the deal at the agreed upon price, the Court of Appeals stated that “the trial court’s reasoning was flawed.” “In contrast to the reliance required to make out a claim for fraud, the general rule is that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue.” The Court pointed out, however, an important condition on the rule, namely that the plaintiff must show that it believed that it was purchasing seller’s promise regarding the truth of the warranted facts.” “If the district court finds that Merrill Lynch candidly disclosed that the September and October financials were wrongly inflated and therefore inaccurate, Allegheny cannot prevail on its claim that Merrill Lynch breached [section] 3.12(c).”

Judicial Interpretations Working Group

The Judicial Interpretations Working Group met during the Committee’s August meeting in San Francisco. Attendees at that meeting discussed the status of the work of the teams that have been formed to research and prepare memoranda pertaining to the jurisprudence interpreting more than 20 different provisions of M&A agreements and ancillary documents, and in particular the paper prepared by Melissa DiVincenzo on cases interpreting the survival provisions of acquisition agreements as contractually limiting the statute of limitations. Rob Copeland, who was involved in the Herring vs. Terradyne case on the subject, also gave a presentation on that case.

The San Francisco meeting was also a joint meeting with the Editorial Working Group on Task Force on the Model Stock Purchase Agreement. The joint group discussed sections of the Model Stock Purchase Agreement where the commentary requires updating, with particular emphasis on jurisprudential developments that have occurred since the Model Stock Purchase Agreement with Commentary was published over a decade ago. We identified several new commentary drafting projects for our Working Group, which provide an opportunity for many new Committee members to become involved in this important project. Therefore, we invite new members to join us in Colorado Springs.

The Colorado Springs meeting of the Judicial Interpretations Working Group will be on Friday, October 12, from 2:00 p.m. until 4:30 p.m., in the Broadmoor Hotel. To join our Working Group, please email Jim Melville at
M&A Market Trends Subcommittee

A huge thank you goes out to Wilson Chu and Larry Glasgow for their tremendous contributions to our Subcommittee during the past three years, making the Subcommittee the largest in the Committee – one that continues to grow at a rapid pace. Also a huge thanks to the many contributors to the 2007 Private Target Deal Points Study, which was released at our San Francisco meeting, the 2007 Private Equity Buyer/Public Target Deal Points Study (quite a mouthful), which was released shortly after our San Francisco meeting, and the 2007 Strategic Buyer/Public Target Deal Points Study, which will be released by the end of October. A welcome goes out to our new vice chairs, Hendrik Jordaan and Jessica Pearlman.

At the Colorado Springs meeting, members of the Subcommittee will be discussing the results of our analysis of sandbagging and non-reliance clauses and the related upcoming supplement to the 2007 Private Target Deal Points Study. We will also be highlighting a number of data points from our soon-to-be released Strategic Buyer/Public Target Study.

In an encore performance to the program presented in San Francisco, members of our Subcommittee will be presenting highlights of the 2007 Private Target Study, 2007 Private Equity Buyer/Public Target Study and 2007 Strategic Buyer/Public Target Study during a 90-Minute Teleconference and Live Audio Webcast on Thursday, October 18, 2007, from 1:00 p.m. until 2:30 p.m. Eastern Time.

The Subcommittee also continues to make progress on our European Study, which is being led by Freek Jonkhart as chair, and Reid Feldman as vice-chair, and our Canadian Study, which is being led by John Clifford as chair, and Kevin Kyte and Mireille Fontaine as vice-chairs.

Our next meeting is scheduled to be held in the Broadmoor Hotel, on Friday, October 12, from 8:00 a.m. until 9:30 a.m. We look forward to seeing you in Colorado Springs.
Programs Subcommittee

The stand-alone meeting in Colorado will feature a Committee Forum, which will follow our full Committee meeting, entitled “When SPACs Attack: The Role of Special Purpose Acquisition Companies in the M&A Market.” The panel is chaired and will be moderated by Mark Morton and includes Committee members Dennis White and Michael Pittenger, along with David Boris of Pali Capital. The panelists will address a number of topics, including: (i) the recent market for SPACs; (ii) SPAC IPO issues; (iii) SPAC structural issues; (iv) issues SPACs confront when selecting a target and negotiating a business combination; and (v) issues experienced by targets when negotiating with a SPAC.

Our Subcommittee is developing its slate for the 2008 Spring and Annual Meetings. If any of you have program ideas, please contact Tom Thompson (thomas.thompson@bipc.com) or Bob Copeland (RCopeland@duanemorris.com).

Thomas M. Thompson
Chair

Technology Subcommittee

Use of our website spiked upward sharply in August due to the release of the 2007 Private Target Deal Points Study and the 2007 Private Equity Buyer/Public Target Deal Points Study. In addition to making the Deal Points studies available to members of our Committee on the website, we have made the complete text of the underlying documents available to Committee members on the Committee’s extranet site. Instructions for accessing those documents are contained on the webpage of the M&A Market Trends Subcommittee. Other resources for the M&A practitioner continue to accumulate on our website, with the site now including papers that have been prepared through our last four meetings.

We are planning again to broadcast via conference call the plenary session of our Fall stand-alone meeting, including the Committee Forum to be held on Saturday, October 13. Dial-in information is provided on page 2 of this issue of Deal Points and will be distributed to Committee members by email prior to the meeting. Written materials to be distributed by our presenters during the session will be posted on the webpage of the Programs Subcommittee in advance of the meeting.

George M. Taylor, III
Chair

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COMMITTEE MEETING MATERIALS

COMMITTEE ON NEGOTIATED ACQUISITIONS
2007 STAND-ALONE MEETING
COLORADO SPRINGS
OCTOBER 12-13, 2007

The Fall stand-alone meeting of our Committee will be held on Friday, October 12, and Saturday, October 13, at the Broadmoor Hotel, in Colorado Springs. Set forth on the following pages are certain materials for the Committee meeting, including a schedule of the meetings of the various subcommittees, task forces and working groups, as well as materials for the Committee Forum.
Schedule of Meetings and Other Activities

Below is the current schedule of the Committee’s meetings and other activities. Please note that this schedule is subject to change. Please refer to the materials you receive upon registration at the meeting for the most up-to-date schedule and for the exact location of each meeting or activity.

Friday, October 12th

Editorial Working Group of the Task Force on the Model Stock Purchase Agreement
8:00 a.m. - 11:00 a.m.
Broadmoor Hotel

M&A Market Trends Subcommittee
8:00 a.m. – 9:30 a.m.
Broadmoor Hotel

Editorial Working Group of the Task Force on Acquisitions of Public Companies
9:30 a.m. - 11:00 a.m.
Broadmoor Hotel

Private Equity M&A Subcommittee
11:00 a.m. – 1:00 p.m.
Broadmoor Hotel

Annual Survey Working Group of the M&A Jurisprudence Subcommittee
12:30 p.m. - 2:00 p.m.
Broadmoor Hotel

Judicial Interpretations Working Group of the M&A Jurisprudence Subcommittee
2:00 p.m. - 4:30 p.m.
Broadmoor Hotel

Committee Reception and Dinner
Reception at 5:30 p.m.
Dinner at 6:30 p.m.
Garden of the Gods Club
Transportation provided from Broadmoor Hotel

Saturday, October 13th

International M&A Subcommittee
8:00 a.m. - 10:30 a.m.
Broadmoor Hotel

Task Force on Acquisitions of Public Companies
10:00 a.m. - 1:00 p.m.
Broadmoor Hotel

Meeting of Committee Chairs and Vice Chairs, Subcommittee, Task Force and Working Group Chairs
1:00 p.m. – 2:00 p.m.
Broadmoor Hotel

Full Committee Meeting
2:00 p.m. - 4:00 p.m.
Broadmoor Hotel

Committee Forum: When SPACs Attack: The Role of Special Purpose Acquisition Companies in the M&A Market
4:00 p.m. - 5:00 p.m.
Broadmoor Hotel

Committee Reception and Dinner
Reception at 7:00 p.m.
Dinner at 8:00 p.m.
Cheyenne Lodge
Transportation provided from Broadmoor Hotel
Immediately after the full Committee meeting on Saturday, October 13, a Committee Forum presentation entitled “When SPACs Attack: The Role of Special Purpose Acquisition Companies in the M&A Market” will be held. In connection therewith, Michael Pittenger and Cara Grisin have submitted the following article of the same name. For a copy of all of the written materials relating to the Committee Forum, please visit the webpage of the Programs Subcommittee located on our Committee’s website.

WHEN SPACS ATTACK:
THE ROLE OF SPECIAL PURPOSE ACQUISITION COMPANIES IN THE M&A MARKET

Michael A. Pittenger
and
Cara M. Grisin

Introduction

Special purpose acquisition companies, or SPACs, are publicly traded shell companies that allow their sponsors to raise capital through an initial public offering for use in seeking to acquire an operating company within a fixed time frame. As such, they are a form of “blind pool” without an operating business or revenues. So called “blind pools” and “blank check” companies have a history of being associated with misuse and abuse, but in the past several years SPACs have managed to overcome many of those negative associations and have been steadily on the rise – increasing in both number and size. According to one source, SPACs have filed to raise more than $7 billion in 2007, a 139% increase over 2006, and SPACs accounted for a quarter of all IPOs in the first half of 2007. Although investments in SPACs are subject to many unique risks, the advantages of the SPAC structure tend to appeal to certain sophisticated investors, particularly hedge funds. As the number of SPACs and the funds they are raising continue to increase, SPACs are likely to maintain their growing presence in the M&A landscape.

General Overview of SPAC Formation and Structure

A SPAC is a corporation formed by a small group of sophisticated investors, or sponsors. The sponsors are often experienced managers with successful investment or operational track records. They initially hold 100% of the SPAC’s common stock and also serve as the SPAC’s management team during the IPO stage and the SPAC’s subsequent search for acquisition candidates.

1 Michael A. Pittenger is a partner and Cara M. Grisin is an associate at Potter Anderson & Corroon LLP in Wilmington, Delaware. The authors would like to express their appreciation to Berton W. Ashman, Jr. and Chris Wallraff for their assistance with this article. The views expressed herein are those of the authors and may not be representative of those of the firm or its clients.

2 See The Best of Our Blogs, Surge Seen in Blank-Check Offerings, The Daily Deal (Friday, September 21, 2007) (citing statistics according to American Growth Capital).

3 Many SPACs are organized under the laws of Delaware or other states. There has been a recent trend, however, toward organizing SPACs under the laws of the Cayman Islands, particularly where the SPAC will be listed on London’s Alternative Investment Market. See Kevin Butler & Richard Fear, Cayman Islands, THELAWYER.COM, June 25, 2007, available at http://www.thelawyer.com.
Most SPACs are formed to pursue an acquisition in a particular industry or market segment, or in a particular geographic region, although some SPACs have opted not to focus on acquisitions in a particular sector or region. The capital needed for a SPAC to pursue an acquisition is raised through an initial public offering of units, most often consisting of one share of common stock and one or two warrants. SPAC IPO prices have been remarkably uniform, generally at $6 or $8 per unit. A recent trend in larger offerings, however, is to offer units at $10, with units consisting of one share of common stock and one warrant. SPACs typically raise anywhere from $30 million to $120 million through their IPOs, but some recent SPACs have raised significantly more. Units normally trade publicly for a period of time following the IPO, with common stock and warrants beginning to trade separately once the SPAC has filed a form 8-K with audited financial statements.

SPAC securities frequently trade on the Over-the-Counter Bulletin Board (“OTC-BB”), although many SPACs have chosen to be listed on the American Stock Exchange (“AMEX”) since the AMEX began accepting applications for listings of SPACs in 2005. AMEX, however, generally subjects SPACs to more intense scrutiny than other potential listings. Other exchanges have been more skeptical of SPAC listings. Nasdaq, for instance, has expressed a concern that SPAC securities might end up in the hands of unsophisticated investors who are unable to appropriately assess the unique risks. Accordingly, it has declined to list SPACs until they have completed an acquisition and become operational. The New York Stock Exchange (“NYSE”) has expressed similar views. Several international exchanges will list SPACs, including London’s Alternative Investment Market (“AIM”), a stock exchange for small capitalization listings.

A key feature of a SPAC is that a certain percentage, generally above 90%, of its IPO proceeds will be placed in an escrow or trust, pending an acquisition or the liquidation of the SPAC. A SPAC’s certificate of incorporation fixes a limited time frame for the SPAC to identify an acquisition target and close an acquisition. Typically, the SPAC will have 18 months from the consummation of its IPO to close an acquisition, which time is extended to 24 months if the SPAC enters into a letter of intent or definitive agreement within the first 18 months. More recently, some SPACs have opted for the greater flexibility of a longer acquisition period. If a SPAC has not closed an acquisition within the fixed time frame, it will be liquidated and

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5 China has been a particular focus of SPACs. See M. Ridgeway Barker & Randi-Jean G. Hedin, SPACs: A Focus on China, THE METROPOLITAN CORP. COUNSEL, Dec. 2006, at 63.

6 M. Ridgeway Barker & Randi-Jean G. Hedin, SPACs – Continuing to Grow and Evolve, The Metropolitan Corp. Counsel, June 2008 [hereinafter Barker].

7 See Krus, supra.

8 Id.

9 See Helen Avery, Spac Spat Probe Hits Wall of Silence, EUROMONEY, June 1, 2006, available at 2006 WLNR 12308725.

10 Id.

11 Id.

escrowed IPO proceeds will be distributed pro rata to holders of IPO shares.

The IPO proceeds that are not held in escrow are typically available, along with capital invested by the sponsors, for the SPAC to use in connection with its search for acquisition candidates and to pay its general operating expenses pending its completion of a business combination, including expenses relating to ongoing compliance with reporting obligations under federal securities laws. The SPACs registration statement usually details the uses of proceeds not held in escrow.

Once a SPAC has reached agreement to acquire an operating company, the acquisition must be submitted for stockholder approval. SPAC certificates of incorporation typically require that any business combination be approved by a majority of the shares of common stock issued in connection with the IPO, even if no stockholder vote on the particular form of business combination is required under the law of the SPAC’s jurisdiction of organization. In connection with stockholder approval, the SPAC must prepare and file preliminary proxy materials with the SEC. Review of preliminary proxy materials by the SEC staff often takes considerable time and involves several rounds of comments due to the enhanced scrutiny that the SEC staff tends to apply to proposed business combinations involving SPACs.

A SPAC’s organizational documents will also permit any holders of IPO shares who vote against the business combination to “convert” their shares into a pro rata interest in the escrowed IPO funds, even if the business combination is approved. If a specified percentage (typically 20% to 30%) of the IPO shares have exercised such “conversion” rights, however, the business combination will not be completed, and the SPAC will be liquidated and the escrowed IPO funds distributed. If a proposed business combination receives the requisite stockholder vote and “conversion” rights have been exercised by the holders of fewer than the specified percentage of IPO shares, then the escrowed IPO funds will be released to the SPAC to be used in completing the business combination.

SPAC Structural and Investor Protection Features

SPACs have a number of structural features designed to enhance investor protection and to make the SPAC a more attractive investment opportunity. Those features, some of which have been mentioned above, typically include:

- A requirement that a certain percentage of the SPAC’s IPO proceeds be placed in escrow with a third party trustee until either the consummation of a business combination or the SPAC’s liquidation. The percentage of funds ordinarily placed in escrow has steadily increased over the past few years and is now typically in the 95% to 100% range, with many recent SPACs escrowing more than 98% of their IPO proceeds. As a way to increase the IPO funds available to be escrowed, it is increasingly common for underwriters to agree to defer a portion of their compensation until consummation of a business combination.
- A requirement that the SPAC consummate a business combination within 18 months of its IPO, or 24 months if the SPAC enters into a letter of intent, definitive agreement, or agreement in principle with

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a target company within 18 months of the IPO.

- A requirement that the SPAC acquire, in a single business combination, one or more operating companies with a combined fair market value in excess of 80% of the SPAC’s net assets at the time of the acquisition.

- A requirement that a majority of the shares of common stock issued in connection with the SPAC’s IPO approve a business combination, whether or not such a vote is required under the law of the SPAC’s jurisdiction of organization.\(^{14}\)

- A right of holders of IPO shares who do not vote in favor of an otherwise approved business combination to “convert” their shares into a \textit{pro rata} share of the escrowed IPO funds.\(^{15}\)

- A prohibition on the SPAC’s consummating a business combination if holders of a specified percentage or more of IPO shares elect to exercise their “conversion” rights. The specified percentage has typically been 20% but has been as high as 30% to 40% for some recent SPACs.

- A requirement that if the SPAC fails to complete a business combination within the time specified, it must liquidate\(^{16}\) and distribute a \textit{pro rata} share of its escrowed IPO proceeds to holders of shares issued in the IPO (the sponsors receiving no escrow distributions for their pre-IPO shares).

- Lock-up agreements for the sponsors pursuant to which they agree to retain their ownership until some time after a business combination.

- Warrant purchase commitment agreements requiring the sponsors to purchase warrants in the public market or directly from the SPAC in order to further align their interests with those of other investors. The warrants are also subject to a lock-up period.

Certain of the foregoing structural features and protections are designed to track restrictions imposed by Rule 419 ("Rule 419") of the general rules and regulations promulgated under the Securities Act of 1933, as amended (the "Securities Act"). Technically, a SPAC does not meet the definition of a “blank check” company to which Rule 419 is applicable, so long as the SPAC files a Form 8-K promptly after consummation of its IPO indicating that its net assets are in excess of $5 million.\(^{17}\) Nonetheless,

\[\text{14} \quad \text{To ensure that any applicable stockholder vote requirements of the jurisdiction of organization are also satisfied, the founders typically agree to vote in favor of the proposed business combination or to vote their shares in accordance with the vote of the IPO shares.}\]

\[\text{15} \quad \text{For SPACs organized under Delaware law, this “conversion” right, sometimes called an “opt out” right, would technically be a redemption of shares and would be subject to statutory limitations on redemption, including the existence of legally available funds from which to redeem the shares. 8 Del. C. §160.}\]

\[\text{16} \quad \text{If a SPAC is organized under Delaware law, it must comply with Delaware’s dissolution and winding-up requirements, including a stockholder vote to authorize dissolution, notwithstanding any provision of the certificate of incorporation that purports to trigger dissolution automatically. See 8 Del. C. § 275.}\]

\[\text{17} \quad \text{Specifically, Rule 419 excludes from its requirements any issuers whose outstanding shares are not deemed to be “penny stock.” 17 C.F.R. § 230.419(a)(2)(ii). According to Rule 3a51-1 under the Securities Exchange Act of 1934 (“Exchange Act”), the definition of “penny stock” does not include issuers with less than three years of operations who have a minimum of $5 million in assets. 17 C.F.R. § 240.3a51-1. Thus, so long as a SPAC has in excess of $5 million in net assets following its IPO, the SPAC’s}\]
to satisfy market expectations and, no doubt, also to lessen the degree of SEC scrutiny, SPACs tend to follow many of the requirements of Rule 419. More recently, some SPACs have opted to implement Rule 419-type features, but with modifications, for example, by increasing the period of time in which a business combination must be consummated or by increasing the percentage of IPO shares for which “conversion” rights must be exercised to prohibit consummation of a business combination, notwithstanding stockholder approval.

Benefits and Pitfalls for SPAC Investors

Investment in a SPAC offers many of the advantages of investing in a private equity fund, while also offering the liquidity of a public market and a “conversion” or “opt out” right if the investor is dissatisfied with the particular business combination. Investment in a SPAC also involves limited downside because a significant portion of the funds raised in the IPO is placed in escrow. An investor’s upside, on the other hand, is potentially significant. Management teams are typically experienced individuals with a proven track record, thus enhancing the prospect that the SPAC will find an appropriate acquisition target.

Aside from the sponsors, hedge funds tend to be the primary investors in SPACs. Hedge funds are attracted to SPAC offerings because they allow the hedge fund to consider its funds fully invested, but also offer the liquidity of a public market and give the fund an “opt out” right when a target acquisition is identified. In addition to the inherent limitation on downside risk, the structure of a SPAC and its securities also offers opportunities to implement complex arbitrage strategies. Investors may own units, common stock, or warrants, separately or in any combination, thus allowing funds to implement investment strategies to hedge and mitigate risk.

Of course, SPAC investors also face significant risks, particularly because a SPAC is not an operating company, has no revenues, and has not even identified a particular target or targets at the time of the IPO. As such, investing in a SPAC has been characterized as a “blind leap of faith.” If a business combination is not consummated within the required period, an investor faces a potential loss of a portion of its initial investment, with the size of the loss depending upon the percentage of IPO proceeds that were placed in escrow. That loss may be more if management incurs additional liability that cannot be satisfied from non-escrowed funds.

Practical Issues Facing SPACs

SPACs face numerous practical issues in carrying out their IPO and their day-to-day activities, as well as in seeking a suitable acquisition candidate and negotiating an acquisition. The following is a list of some of the common issues SPACs confront:

- SPAC filings with the SEC, both at the IPO stage and the proxy solicitation/business combination stage, have generated significant interest on the part of the SEC staff, which has expressed concerns with many SPAC structural

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18 See Krus, supra; Bruce Rader & Shane de Burca, SPACs: A Sound Investment or Blind Leap of Faith?, Insights, Jan. 2006, at 4-5 [hereinafter “Rader”].

19 See generally Vyvyan Tenorio, Pow! SPAC! Boom!, DAILY DEAL, May 26, 2006, available at 2006 WLNR 9038125; Rader, supra, at 4-5.

20 Rader, supra note 2, at 4-5.

21 Barker, supra.

22 Rader, supra, at 4-5.
issues, as well as potential sponsor conflicts of interest. As a result, it may be more time consuming and costly to prepare and clear registration and proxy statements for a SPAC than for other public companies.

- As a public company, a SPAC is subject to reporting requirements under the federal securities laws, including compliance with the Sarbanes-Oxley Act of 2002. If listed on an exchange, a SPAC must also comply with the exchange’s listing requirements. Compliance with reporting and listing requirements can be time consuming and costly.

- SPACs that trade on the OTC-BB are subject to state blue-sky laws, and their securities may not be sold in many jurisdictions. Moreover, registering a SPAC IPO under state blue-sky laws can be challenging.

- SPACs have a limited time frame in which to identify potential acquisition candidates, conduct due diligence, select a target, and negotiate a definitive agreement. Accomplishing all that within the fixed time frame is often made more difficult by limitations on the target’s industry or the geographic region in which it operates, as well as by the requirement that the target’s fair market value exceed 80% of the SPAC’s net assets. If a deal is not consummated within the specified time frame, the SPAC’s organizational documents require that it be dissolved and that the IPO proceeds be distributed to stockholders.

The fixed time frame not only puts added pressure on management, but may make some targets less interested in being acquired by a SPAC and may give those targets that are interested additional leverage to negotiate a favorable deal.

- The requirement that a business combination be approved by the holders of IPO shares and the availability of “conversion” rights for dissatisfied stockholders give rise to additional issues:

  o Preparing proxy solicitation materials for stockholder approval of a business combination, as discussed above, can be a lengthy and costly process, especially in view of the often stringent SEC review process. Where a SPAC has taken a considerable amount of time to identify an acquisition candidate and negotiate a business combination, additional delays arising from the SEC review process can sometimes cause the SPAC to run up against the 18 month/24 month window for completing the acquisition.

  o The availability of voting and “conversion” rights also gives rise to arbitrage opportunities, particularly where a SPAC’s shares are trading

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23 Id. at 3.


25 A number of SPACs have elected to seek an extension of the acquisition period by obtaining a stockholder vote to amend their certificates of incorporation. Seeking an extension may pose additional issues with respect to whether such an amendment is permissible under the certificate of incorporation and applicable law, the vote required for such an amendment, the appropriate treatment of stockholders who vote against an extension, and whether obtaining an extension could give rise to disclosure claims based on statements made in the SPAC’s registration statement/prospectus.
near or below the *pro rata* amounts held in escrow. Such opportunities can be particularly problematic in view of the prohibition on consummating a business combination if holders of a specified percentage of IPO shares have exercised “conversion” rights. In some instances, stockholders have even been accused of using the threat of “conversion” to carry out greenmail.26

Practical Issues Facing Target Companies Seeking to be Acquired by a SPAC

An acquisition by a SPAC can offer significant benefits for a target company, including providing access to additional capital and the opportunity to become a public company without the cost and burden of going through the IPO registration process. Target companies nonetheless face unique issues when negotiating and seeking to consummate an acquisition by a SPAC:

- The limited time frame available for a SPAC to consummate an acquisition may in some cases give a target a bit more leverage to negotiate a favorable deal, but the time pressures resulting from a SPAC’s unique structure can also impose additional burden and expense on a target that might not be present in the context of another type of acquisition.

- A SPAC’s limited window period for consummating an acquisition also gives rise to execution risk for the target. Absent a stockholder vote in favor of an extension of the acquisition period, if a business combination is not consummated prior to the expiration of the acquisition period, the SPAC must dissolve and is not permitted to close, even if it has a signed deal in place.

- For a number of reasons, including the requirement that a SPAC’s stockholders approve any business combination and the resulting need for a proxy statement subject to the SEC review process, SPAC deals often take longer to close than other types of acquisitions. Such delays further enhance consummation risk.

- The requirement that a business combination be approved by the holders of a SPAC’s IPO shares and the availability of “conversion” rights for dissatisfied SPAC stockholders – as well as the resulting arbitrage and greenmail opportunities created thereby – also increase consummation risk.

- Notwithstanding the additional delay and inherent risks associated with a SPAC deal, a target company’s ability to negotiate for meaningful deal protection in the form of a reverse termination fee and/or expense reimbursement is limited. SPACs ordinarily have limited funds available from which to pay such fees and expenses, given that the bulk of IPO proceeds are tied up in escrow. When targets have been successful in negotiating break up fees from SPACs, they have typically been far lower than market.

- As discussed above, the opportunity to become a public company through acquisition by a SPAC is often viewed as an advantage from the perspective of the target. But becoming a public company also may have disadvantages such as the additional costs and burden of complying with requirements under federal securities law, including the Sarbanes-Oxley Act, and applicable listing requirements.

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Conclusion

SPACs are becoming an increasingly popular alternative investment vehicle, both in the United States and abroad. While SPACs offer unique benefits to their sponsors and investors, they also pose unique risks to sponsors, investors, and target companies and give rise to a host of distinct practical hurdles. As the presence of SPACs in the M&A landscape grows, M&A practitioners should be cognizant of both the benefits and potential pitfalls surrounding SPACs and acquisition transactions involving SPACs.

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