FROM THE CHAIR

By Leigh Walton

I trust that many of you are planning to attend (in person or by phone) the stand-alone meeting of our Committee to be held in Miami on Friday, January 28, and Saturday, January 29. Our in-person registration is at record levels, so we are confident that we will have an ample quorum for business and fun. Our meetings will be held at the Ritz-Carlton Coconut Grove, located at 3300 Southwest 27th Avenue, Coconut Grove.

The full Committee meeting will be held Saturday afternoon, beginning at 1:00 p.m. Eastern Standard Time. Most of our meetings will be available by conference telephone. The dial-in information for the full Committee meeting and the Committee Forum that follows, both to be held in the Grand Ballroom, is listed below. Other Subcommittee and Task Force meetings will be held in either the Grand Ballroom or the Verdi Room, also listed below:

Grand Ballroom
Domestic (US and Canada): 866-646-6488
International: 707-287-9583
Conference Code: 1394196854

Verdi Room
Domestic (US and Canada): 866-646-6488
International: 707-287-9583
Conference Code: 8688026251

Dial-in information for subcommittee and task force meetings is also being circulated by the respective chairs and should be available

(continued on next page)
New Projects

A major focus of the Miami meeting will be the consideration of new projects for our Committee. The recent completion, or near completion, of several major projects allows us the flexibility to consider new endeavors. The head of our Task Force on New Projects, Bruce Cheatham, will chair a Task Force meeting on Friday. Bruce has provided a report that appears later in this issue of Deal Points highlighting potential undertakings. I hope everyone will plan to attend this session.

Industry Impact

At our full Committee meeting, I propose that we try something new. Traditionally, our Committee has divided its deal analysis along structural lines – we have analyzed public deals and private deals, asset sales, and stock sales. As an experiment, I propose we supplement our analysis with an industry focus.

I envision that this initiative, which I’ll call “Industry Impact,” would serve at least two functions. First, there are variations in transactions that are industry specific, stemming from regulatory considerations and historic conventions. Through Industry Impact, our Committee members who only sporadically advise clients in the sector can gain greater insight.

Second, Industry Impact will allow our members to showcase their expertise. Thus, if a Committee member’s client needs specialized expertise, the Committee member can knowledgeably retain co-counsel to bolster the representation. I have long believed that a major benefit of our Committee is to allow us to develop a robust rolodex of skilled deal professionals who are diversified from a geographic and expertise standpoint. Our familiarity with available competent expertise, I believe, is a great service we offer our clients.

I propose to initiate Industry Impact with a brief presentation on M&A trends in the U.S. healthcare industry. Recently enacted healthcare reform contains many features that will foster consolidation in the payor, provider, pharmaceutical, and medical device industries. Additionally, there are revenue recognition, regulatory compliance, and successor liability issues for providers whose revenue comes from governmental payors that are unique to healthcare deals that our members may find interesting.

If Industry Impact is well received, we will accept volunteers to provide brief (no more than 20 minutes) presentations on other industry segments at upcoming full Committee meetings. You can submit your interest to our Programs Subcommittee, chaired by David Albin (dalbin@fdh.com), Bob Copeland (rcopeland@sheppardmullin.com), and Yvette Austin-Smith (ysmith@srr.com).

Dinners

We have two special Committee dinners planned. On Friday evening, we will dine at Ortanique on the Mile, 278 Miracle Mile, Coral Gables. This dinner is sponsored by Appleby. Saturday’s dinner will be at the Blue Door at the Delano – South Beach, 1685 Collins Avenue, Miami Beach and is sponsored by Merrill Datasite. We very much appreciate the support received from our dinner sponsors. Because of our record attendance, Mark Page and I have been scrambling to accommodate everyone. We have secured extra space for our Friday dinner. While things may be a bit tight, we hope to make it work. We are still working on Saturday night. Stay tuned.
Post-Closing Earnouts in M&A Transactions: Avoiding Common Disputes

By Kevin R. Shannon and Michael K. Reilly

The prospective parties to an M&A transaction often have different views regarding the value of the subject company, which can make it difficult to agree upon a purchase price. Of course, such different valuation perspectives may not be surprising given that the value of a business typically is determined by reference to its expected future performance or cash flows. The seller may be optimistic with regard to the future prospects, and therefore ascribe a higher value to a business than the buyer, which may be more conservative. One common way to bridge the gap between the parties’ valuation positions is to have a portion of the purchase price based on the future performance of the company. Such a provision, which is often called an “earnout,” entitles the seller to receive additional payments if the business meets certain contractual targets post-closing.

Although an earnout may appear to be an effective means to resolve a disagreement over price, earnout provisions often result in litigation. Indeed, the Delaware Court of Chancery recently has observed as follows:

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1 Messrs. Shannon and Reilly are partners at Potter Anderson & Corroon LLP in Wilmington, Delaware. Mr. Shannon practices primarily in the areas of corporate and commercial litigation. Mr. Reilly practices primarily in the area of corporate transactions. The views expressed are those of the authors and may not be representative of those of their firm or its clients.
[A]n earnout ... typically reflects [a] 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.... 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.²

There are two primary types of disputes relating to contractual earnouts. First, the parties may disagree as to whether the applicable targets for an earnout payment were satisfied (e.g., whether the EBITDA target was met). The other common dispute involves disagreements as to why the earnout targets were not satisfied (e.g., whether the buyer adequately supported the business after the closing).³

The parties’ rights and obligations with respect to an earnout provision are contractual in nature, and therefore the resolution of an earnout dispute often turns on the specific language negotiated by the parties. Set forth below is a summary of certain Delaware decisions addressing earnout disputes, which provide insight regarding how courts will interpret such provisions. More importantly, the decisions also demonstrate how certain disputes might be avoided by careful drafting of the contract language.

**Disputes Regarding Whether the Earnout Target Was Satisfied**

The Delaware Court of Chancery has noted that “[t]here are always choices to be made in accounting treatment” -- and such choices can have a significant impact on the calculation of the earnout.⁴ As illustrated by the decisions below, in light of the buyer’s potential discretion in accounting for the operation of the business post-closing, parties would be well-served to carefully draft the agreement so as to make clear how the earnout should be calculated (and determine the earnout consistent with the agreement) so as to reduce the likelihood of litigation.

**Comet Systems, Inc. Shareholders’ Agent v. MIVA, Inc.**

The Court of Chancery’s decision in *Comet Systems, Inc. Shareholders’ Agent v. MIVA, Inc.*⁵ presents a typical case in which the dispute related to whether the earnout target was satisfied. In that case, MIVA, Inc. (“MIVA”) acquired Comet Systems, Inc. (“Comet”) pursuant to a merger agreement that included an earnout provision. Specifically, the earnout provided for potential additional payments of up to $10 million, half of which could be earned for meeting the performance targets specified in each of 2004 and 2005. In each year, the earnout payment was determined based on Comet’s performance relative to three performance goals, with each goal worth one-

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³ The Delaware Court of Chancery has noted that “[e]arnouts frequently give rise to disputes, and prudent parties contract for mechanisms to resolve those disputes efficiently and effectively.” *Aveta Inc. v. Bengoa*, 986 A.2d 1166, 1173 (Del. Ch. 2009). In fact, many agreements expressly set forth procedures for the resolution of earnout disputes, such as requiring that the disputes be submitted to arbitration. Courts will enforce such agreements, and can impose sanctions for a failure to comply. *Id.* at 1181-90 (holding the seller in contempt for failing to participate in the contractually mandated arbitration relating to an earnout dispute).

⁵ 980 A.2d 1024 (Del. Ch. 2008).
third of the total possible earnout compensation for that year. Achievement of a portion of a goal would result in a *pro rata* payout with respect to that goal -- except that no payment was due if the company did not achieve at least 66% of the goal.

In connection with the closing of the transaction, Comet paid a bonus (the “Bonus”) of approximately $800,000 to its employees. The Bonus was referenced in the merger agreement, but was not addressed in the earnout provision.\(^6\) In order to meet the revenue goal contained in the earnout, the revenue per user had to exceed the cost per user, which was defined as “Operating Costs Excluding Amortization and One-time, Non-recurring Expenses.”\(^7\) In calculating the earnout, MIVA treated the Bonus as an operating cost, which was not excluded as a “one-time, non-recurring expense.” As a result, the revenue target was not achieved and the earnout payment was reduced significantly. The primary issue presented was whether the Bonus was a “one-time, non-recurring expense” that should have been excluded from MIVA’s costs for the purpose of calculating the earnout.

MIVA asserted that the Bonus was an ordinary cost of business -- not a one-time non-recurring expense -- given that Comet regularly paid bonuses, and the purpose of the bonus was to retain and incentivize Comet’s employees, which is the typical purpose of a bonus. MIVA further asserted that the Bonus was paid to encourage the employees to help make Comet successful, and that it would be inappropriate when calculating the earnout to include the revenues resulting from the employees’ efforts without including the attendant expense (i.e., the Bonus). Comet responded that the Bonus was materially greater than any previous bonus paid by the company, and it was based on a percentage of the merger consideration. Unfortunately, the merger agreement did not define what was intended by the term “one-time, non-recurring expense,” and the Court found that the parties’ reference to accounting principles was not helpful in determining the meaning.\(^8\)

The Court concluded that the Bonus qualified as a “one-time, non-recurring expense” pursuant to the “plain, unambiguous meaning of the merger agreement.”\(^9\) In support of its conclusion, the Court focused on the purpose for which the “one-time, non-recurring expense” exclusion was being applied. Specifically, the Court noted as follows:

> Earnouts are typically used where the buyer and seller cannot agree on a price because the seller is more optimistic

\(^6\) The merger closed on March 22, 2004. Significantly, the earnout was based on the entire year of 2004 -- both before and after the closing of the merger. *Comet*, 980 A.2d at 1027-28.

\(^7\) *Comet*, 980 A.2d at 1028.

\(^8\) Both sides presented testimony from accounting experts to support their positions, and the accounting experts noted that the contractual language (i.e., “one-time, non-recurring expense”) was similar to the definition of an extraordinary item under GAAP. *Comet*, 980 A.2d at 1031, n.26. The Court, however, did not apply the GAAP definition, noting that: “the parties chose to use the phrase ‘one-time, non-recurring expense’ and not ‘extraordinary item in accordance with GAAP practice.’” The obvious implication is that the parties chose this alternative phrase precisely because they did not mean ‘extraordinary item in accordance with GAAP practice,’ particularly in light of the fact that the parties obviously knew how to invoke GAAP standards when they wanted to.” *Id.* (quotations and emphasis in original).

\(^9\) *Comet*, 980 A.2d at 1032.
about the future prospects of a business than is the buyer. As a result, charges and costs which occur as a result of the merger and are not expected to be representative of future costs in the business are reasonably excluded. The natural reading of “one-time, non-recurring expenses” is to exclude exactly such charges.\footnote{Id. at 1031 (footnotes omitted).}

The primary lesson from the Comet decision is obvious: the parties should agree in advance -- and set forth in the contract -- how specific expenses should be treated for the purposes of determining the earnout. Although it is not possible to anticipate all expenses that may be incurred following closing, the Bonus at issue was expressly contemplated by the parties and referenced in the merger agreement. In addition, to the extent that the earnout purports to include or exclude certain types of revenues or expenses (e.g., one-time, non-recurring expenses), the contract should define as precisely as possible what the parties intend by such language.

\textit{Chambers v. Genesee & Wyoming Inc.}

Another example of a dispute regarding the calculation of an earnout is described in the Court of Chancery’s decision in \textit{Chambers v. Genesee & Wyoming Inc.}\footnote{2005 WL 2000765 (Del. Ch. Aug. 11, 2005).} That decision involved two stock option agreements that arose in connection with a buyout by Genesee & Wyoming Inc. (“Genesee”) of the plaintiffs’ interest in Genesee Rail-One (“GRO”). The agreements contained an earnout, which was tied to GRO’s EBITDA as defined in the agreements. As noted by the Court, however, “EBITDA … can be a slippery concept, and it is this indefiniteness-plus the characteristic divergence in the sellers’ and the buyers’ interests that arises all too often in calculating whether the targets in ‘earn-out’ contracts were achieved—that has led to the current conflict.”\footnote{Id. at *1.}

Stated generally, the agreements provided that plaintiffs would receive additional compensation, in the form of Genesee stock options, if GRO achieved $9 million of EBITDA in any of the five years, 1999-2003. Following the 1999 buyout, GRO’s publicly-reported EBITDA exceeded $9 million in four of the five years covered by the earnout. Genesee, however, asserted that it was not obligated to vest the options because EBITDA \textit{as defined in the Agreements} had not exceeded $9 million in any year.

The discrepancy arose because Genesee made adjustments to its publicly reported EBITDA in order to determine whether plaintiffs’ options vested under the agreements. Not surprisingly, the adjustments served to reduce EBITDA such that plaintiffs were not entitled to additional compensation. The dispute focused on whether Genesee’s adjustments were proper under the agreements.

The Court quickly rejected Genesee’s assertion that, absent the adjustments, the calculation of EBITDA (and resulting additional compensation) would be “unfair.” Specifically, the Court noted that the dispute was “purely commercial,” and that the Court need not consider such fairness arguments or the accounting principles cited by Genesee.\footnote{Id. at *6.} Rather, the Court focused on “contract law” and the “plain language of the contract itself.”\footnote{Id.} For example, although it might be appropriate and
consistent with accounting principles to allocate certain costs to GRO, the agreements specifically excluded such allocations for the purposes of calculating the earnout. Similarly, the agreements did not permit Genesee to expense certain labor costs (for the purpose of determining the earnout) that it had capitalized for its public financial statements. The Court therefore concluded that Genesee’s calculation of EBITDA for purposes of the agreements was flawed.

The decision in Genesee serves to highlight the fact that the earnout will be determined based on the contract negotiated by the parties, and not by reference to fairness or general accounting principles. Accordingly, it is important to articulate clearly how the earnout will be calculated. Moreover, to the extent that adjustments are made to the company’s financial results for the purpose of determining the earnout, such adjustments must be expressly permitted under the contract.

William J. LaPoint v. AmerisourceBergen Corp.

The Court of Chancery’s decision in William J. LaPoint v. AmerisourceBergen Corp.\textsuperscript{15} presented a number of issues relating to an earnout provision. LaPoint involved the merger between Bridge Medical, Inc. (“Bridge”) and AmerisourceBergen Corporation (“ABC”). Under the terms of the merger agreement, ABC agreed to pay Bridge stockholders an initial $27 million dollars, and further consented to earnout payments to former Bridge stockholders contingent upon certain EBITA targets being met in 2003 and 2004. These payments could vary between $55 million and zero, depending on the EBITA that Bridge achieved. The Court noted that “the earnout provision provided both protection to ABC shareholders and an incentive for Bridge to perform.”\textsuperscript{16} Among other claims, the plaintiffs asserted that “ABC miscalculated the agreed-upon adjustments to EBITA in order to ensure that plaintiffs received no payment.”\textsuperscript{17}

The first dispute related to the treatment of certain transactions for the purpose of the earnout. Specifically, with regard to bundled products, the contract called for the application of a discount equal to the “average” discount in the last five unbundled contracts.\textsuperscript{18} ABC offered numerous arguments to support its contention that the discount should be calculated using a “weighted average,” reflecting the size of the transactions, which resulted in a lower earnout payment. Although the Court recognized that using a weighted average was a “plausible option” for the parties, the merger agreement did not so provide.\textsuperscript{19} Accordingly, the Court rejected ABC’s argument finding that ABC sought to “invoke the merger agreement that it wishes it had signed, rather than the merger agreement that it drafted.”\textsuperscript{20}

ABC also asserted that Bridge’s EBITA should be adjusted downward by approximately $1.3 million to reflect the fact that Bridge spent only $2.4 million in research and development expenses.\textsuperscript{21} The merger agreement provided, however, that such expenses could not be reduced below $3.7 million without the consent

\textsuperscript{15} 2007 WL 2565709 (Del. Ch. Sept. 4, 2007), aff’d, 956 A.2d 642 (Del. 2008).
\textsuperscript{16} Id. at *2.
\textsuperscript{17} Id. at *7.
\textsuperscript{18} Id.
\textsuperscript{19} Id. at *12.
\textsuperscript{20} Id.
\textsuperscript{21} 2007 WL 2565709, at *8.
Although it was undisputed that Bridge failed to comply with the contract, the Court noted that such failure did not require an adjustment to EBITA for the purposes of the earnout. Specifically, the Court opined as follows:

[ABC] would have done well to have included in the original draft of the merger agreement a provision stating that if plaintiffs unilaterally reduced planned expenditure in any area by more than a given amount, that amount would in turn be applied to the end of year EBITA adjustment in 2003 or 2004. Instead, the merger agreement simply provides that Bridge shall expend a certain sum of money in R&D in 2003…. No rational reading of the contract would support the conclusion that an adjustment in EBITA would be an accurate reflection of expectation damages.\(^{23}\)

The Court similarly rejected another proposed adjustment to EBITA based on the assertion that revenue recognition with regard to a specific transaction was “in violation of GAAP.”\(^{24}\) The plaintiffs responded that the merger agreement expressly provided for the challenged revenue recognition. Once again, the Court determined that the dispute was resolved by the language of the merger agreement, which set forth how the transaction was to be handled for the purpose of the earnout. The Court further noted as follows:

Had defendant wished to ensure that the revenue credit due to plaintiffs was recognized only when the relevant sales were recognized under GAAP, it would have been easy to draft such a contract. Defendant did not do so, however, and cannot be heard to complain now that the standards of ¶ 34 are too lenient.\(^{25}\)

The decision in LaPoint further serves to highlight the importance of careful drafting of the earnout provision. As explained by the Court, “[h]aving arrived at the courthouse realizing that the merger agreement exposes [it] to considerable risk, [ABC] now asks the Court to subtly rewrite it by inserting provisions that simply do not exist.”\(^{26}\) The Court, however, will not rewrite the merger agreement -- even if enforcing the terms as written may result in a purported windfall for one party.

**Disputes Regarding Post-Closing Management of the Company**

The ability of a business to achieve the earnout targets will necessarily depend on the management of the business post-closing, including the resources and support that are provided to the business. This creates potential conflicts between the buyer and the seller. For example, the seller understandably wants the business managed so as to maximize the earnout payments. In contrast, the buyer may determine that it does not make economic sense to pursue a course of conduct that might otherwise benefit the seller. Not surprisingly, as illustrated by the cases discussed below, this inherent tension often results in litigation.

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\(^{22}\) *Id.*

\(^{23}\) *Id.* at *11.

\(^{24}\) *Id.* at *14.

\(^{25}\) *Id.* at *15.

\(^{26}\) *Id.* at *11.
William J. LaPoint v. AmerisourceBergen Corp.

In LaPoint, which is briefly summarized above, the Bridge stockholders expressly required that ABC promote Bridge’s business post closing. Specifically, the merger agreement provided as follows:

[ABC] agrees to (and shall cause each of its subsidiaries to) exclusively and actively promote [Bridge’s] current line of products and services for point of care medication safety. [ABC] 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 [Bridge’s] current line of products and services.

In addition, the merger agreement addressed the risk that the surviving entity might exert its influence post-closing in order to avoid the earnout payments, providing as follows:

[ABC] will act in good faith during the Earnout Period and will not undertake any actions during the Earnout Period any purpose of which is to impede the ability of the [Bridge] Stockholders to earn the Earnout Payments.

Thus, the merger agreement provided protection to former Bridge stockholders in the event that they are unable to achieve their EBITA targets and, thus, receive their contemplated merger consideration due to action or inaction on the part of ABC.

As noted by the Court, however, much of the merger agreement “consists of the sort of aspirational statements mentioned above,” which have “proven too fragile to prevent the parties from devolving into the present dispute.” For example, although the terms of the agreement undoubtedly required ABC to “actively” promote Bridge products, the parties disagreed as to whether ABC satisfied that “nebulous requirement.” Ultimately, however, the Court determined that ABC’s conduct, including promoting competing products, was inconsistent with its obligation to actively and exclusively promote Bridge’s products. That determination, however, did not mean that Bridge stockholders were entitled to the full amount of the earnout. To the contrary, the Court concluded that “that even had ABC acted in utmost good faith, which it certainly did not, Bridge would have been highly unlikely to earn a sale and thus contribute to the EBITA calculations for purposes of the earnout.” The Court further concluded that the plaintiffs failed to demonstrate that ABC’s failure to promote Bridge led to damages that could be fixed to a reasonable degree, and therefore awarded only nominal damages to the plaintiffs.

In addition, the Court rejected the plaintiffs’ assertion that ABC breached its contractual obligations by failing to enter into a joint venture with a third party, which was expected to increase the likelihood that the earnout would be paid. The Court held that “[a]lthough ABC could not unreasonably withhold consent from a transaction that would allow [the] shareholders to earn their earnout payments, nothing in the merger agreement obligated ABC to enter into an unprofitable transaction.”

27 2007 WL 2565709, at *2 (emphasis in original).
28 Id. (emphasis in original).
29 Id.
30 Id.
31 Id. at *4.
32 Id. at *10 (emphasis omitted).
As illustrated by the decision in LaPoint, the terms of an earnout provision might have significant implications with regard to the buyer’s obligations and discretion regarding the management of the business post-closing. To avoid uncertainty regarding such obligations and related disputes, it is important that, to the extent possible, the buyer’s obligations be set forth in objective, rather than aspirational, terms. For example, the agreement could set forth a minimum amount that must be spent on advertising and sales support each year for the business, rather than a vague obligation to actively promote the business. Moreover, the agreement should set forth the consequences of failing to comply with such contractual obligations because, as illustrated by the Court’s damages analysis in LaPoint, it may be difficult to establish that the earnout targets would have been achieved but for the breach.

**Airborne Health, Inc.**

The Court of Chancery’s decision in Airborne Health, Inc. v. Squid Soap, L.P. provides another example of a situation where the undisputed failure to support the business post-closing did not result in the payment of the earnout. In that case, Airborne acquired Squid Soap pursuant to an asset purchase agreement. Squid Soap agreed to sell its assets for $1 million in cash at closing, plus the potential for earn-out payments of up to $26.5 million if certain targets were achieved. As noted by the Court, “[b]ased on an earn-out of this magnitude (viewed in terms of the portion of total potential consideration), the plain inference is that Squid Soap believed that its business had tremendous value and was willing to bet heavily on that proposition.” The agreement was unusual in that it provided that, if Airborne failed to spend a certain amount on marketing and advertising to support Squid Soap’s products or failed to achieve certain sales targets, the assets would be returned to Squid Soap.

Following the closing of the transaction, Airborne faced some significant problems with its existing business. As a result, Airborne failed to provide the minimum level of marketing and advertising support for Squid Soap’s products as required under the agreement. In addition, Airborne failed to achieve the minimum sales targets for Squid Soap’s products. Pursuant to the terms of the agreement, in light of its failure to achieve the minimum sales targets, Airborne attempted to return the assets to Squid Soap. Squid Soap refused to accept the assets, however, and instead sued for fraud in Texas. Airborne responded by filing suit in the Delaware Court of Chancery for a declaration that Airborne was not liable under the agreement.

Although Squid Soap asserted numerous claims, the one most relevant to the earnout was Squid Soap’s allegation that Airborne breached the agreement by failing to spend the minimum amounts set forth in the agreement to market Squid Soap’s products. The Court, however, rejected this claim, noting that the agreement did not require Airborne to spend a minimum amount. Rather, the agreement provided that the assets would be returned to Squid Soap if Airborne failed to spend the minimum amount. The Court also rejected Squid Soap’s claim that Airborne committed fraud by failing to disclose certain claims and litigation against Airborne, which purportedly impaired Airborne’s ability...

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33 984 A.2d 126 (Del. Ch. 2009).
34 Id. at 132.
to successfully market Squid Soap’s products. Once again, the Court focused on the specific language of the agreement and noted that Airborne made no representations regarding its ability to achieve the earnout targets. Ultimately, the Court concluded that the agreement provided downside protection to Squid Soap in the event that Airborne failed to adequately support Squid Soap’s products -- it required that Airborne return of the assets to Squid Soap. The Court therefore refused to rewrite the agreement so as to provide additional relief to Squid Soap.

This decision once again makes clear that the Court will enforce the agreement negotiated by the parties as reflected in the terms of the contract. As in LaPoint, the Court noted that the buyer’s failure to provide the required support to the business post-closing will not result in an automatic recovery for the seller. Rather, the seller must demonstrate that such failure entitles it to relief under the contract. The decisions therefore highlight the fact that the contract should be clear and the parties should understand not simply the obligations of the buyer to support the business post-closing, but also the consequences of a breach of such obligations.

**Conclusion**

The earnout is a critical part of a transaction, and can represent a substantial portion of the total consideration. The achievement of the earnout, however, necessarily depends on the buyer’s management of the business post-closing, and how the buyer accounts for the post-closing financial performance of the business. As a result, to the extent that the buyer has discretion, it may be incentivized to manage, or to account for, the business in a manner that reduces the additional amounts that are due to the seller. In light of this potential conflict between the interests of the buyer and the seller, it is not surprising that disputes often arise relating to earnout provisions. As explained above, however, it may be possible to avoid some of the potential disputes through careful drafting of the earnout provision.

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Offshore Law Firm of the Year
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Legal Week

Simon Raftopoulos, Partner
Email: sraftopoulos@applebyglobal.com
Cayman

Stephen James, Partner
Email: ssjames@applebyglobal.com
Cayman

Cameron Adderley, Partner
Email: cadderley@applebyglobal.com
Bermuda

applebyglobal.com

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THE RIGHT PEOPLE. THE RIGHT PLACES.
THE RIGHT GUIDANCE.

Offshore Legal, Fiduciary & Administration Services
This article discusses the recent decision by the Delaware Court of Chancery in the matter of SV Investment Partners, LLC v. ThoughtWorks, Inc. Specifically, the article discusses the Court’s interpretation of surplus, corporate solvency, and the concept of “funds legally available” under Delaware statutory and common law precedent.

In a recent decision by the Delaware Court of Chancery, the Court addressed a dispute between a group of affiliated investment funds (including their advisor, SV Investment Partners, LLC) (collectively, “SVIP”), and ThoughtWorks, Inc. (“ThoughtWorks” or the “Company”), a portfolio company of SVIP. The dispute centered on the language of a redemption right that had been negotiated by SVIP at the time of its initial investment in the Company. At the heart of the dispute was the meaning of “funds legally available,” as the term was used in the redemption provision of the certificate of incorporation, and its relation to the concept of surplus under the General Corporation Law of the State of Delaware (the “DGCL”) and common law precedent. In its opinion, the Court suggests that, even in the absence of a “funds legally available” limitation, directors of Delaware corporations should employ a solvency analysis in determining whether a stock redemption is permissible under Delaware law.

Background of the Company and the Investment

ThoughtWorks is an information technology services firm that develops custom business software applications and provides related consulting services. In 1999, after a period of significant growth, ThoughtWorks began to explore the possibility of an initial public offering (“IPO”) of its common stock. Prior to the IPO, the Company sought private funding from an institutional investor in an effort to enhance its credibility with the public markets. Upon learning of the ThoughtWorks opportunity, SVIP expressed interest and began to negotiate terms of an investment with the Company. Given the strong IPO market at the time, both parties anticipated an IPO within a few years of SVIP’s investment. Nevertheless, the parties also discussed redemption rights for SVIP’s shares in the event that an IPO did not materialize. Ultimately, the parties agreed on a redemption right for cash after five years, subject to, among other things, ThoughtWorks’ having “funds legally available” at the time of the redemption. The redemption provision

1 T.J. Hope, CFA is a Director in the Valuation & Financial Opinions Group at Stout Risius Ross (SRR). He specializes in fairness and solvency opinions, transaction and dispute advisory-related valuations, shareholder and succession planning valuations, and other tax, corporate, and litigation-related matters. Mr. Hope can be contacted by phone at 646.807.4223 or by email at thope@srr.com. Roxanne L. Houtman is an associate in the Corporate Group at Potter Anderson & Corroon LLP. Her practice involves counseling Delaware corporations on corporate law and governance issues. She also represents buyers and sellers in negotiated acquisitions and divestitures. Ms. Houtman can be contacted by phone at 302.984.6177 or by email at rhoutman@potteranderson.com.

contemplated a repurchase of 100% of SVIP’s shares upon exercise of its redemption rights. The provision also addressed a scenario wherein the Company would not have sufficient funds to redeem all of the shares of preferred stock. Under such circumstances, ThoughtWorks was obligated to use its available funds to redeem the shares on a pro-rata basis from each holder, and to do so on a continuous basis until its obligations had been completely fulfilled.

In April 2000, SVIP invested $26.6 million in ThoughtWorks in exchange for approximately 3.0 million shares of preferred stock.

The IPO Bubble Bursts and a Redemption is Explored

After peaking in 2000, the public equity markets declined precipitously in the following years, and IPO activity also fell considerably. It became clear that an IPO was no longer a viable liquidity option for SVIP, and the parties began discussions of how the Company might redeem the preferred stock instead. After an internal analysis and an attempt to raise additional outside capital from the debt markets, the Board of Directors of ThoughtWorks (the “Board”) concluded in 2003 that it likely could not pay the approximately $43 million (including accrued but unpaid dividends) that would be due SVIP to redeem its preferred stock in April 2005, and offered to redeem the stock at a discounted amount. SVIP rejected this offer and exercised its redemption rights effective July 2005.

In response, the Board underwent an extensive process to evaluate the Company’s finances to determine whether (i) it had surplus from which a redemption could be made, (ii) it had or could readily obtain cash for a redemption, and (iii) a redemption would endanger the Company’s ability to continue as a going concern. Based on this analysis, and in consideration of the highly cyclical and volatile nature of the Company’s cash flows, the Board determined that ThoughtWorks had $500,000 of funds legally available, and offered to redeem preferred stock in that amount. It underwent the same process in each of the next sixteen quarters, ultimately offering to redeem 214,484 shares of ThoughtWorks’ preferred stock for a total of nearly $4 million. Throughout this process, SVIP declined to submit its stock certificates for payment.

SVIP’s Claims

SVIP objected to the Board’s periodic approach to redemption of its preferred stock. In February 2007, it filed an action seeking a declaratory judgment as to the meaning of the phrase “funds legally available,” and a monetary judgment for the lesser of the full amount of ThoughtWorks’ redemption obligation or the full amount of “funds legally available.” SVIP alleged that the term “funds legally available” simply meant an amount equal to the Company’s “surplus,” a well-defined concept under Delaware law, and it presented an expert at trial who opined that ThoughtWorks’ surplus ranged between $68 to $137 million. Thus, SVIP’s argument ultimately rested on the equivalence of the terms surplus and “funds legally available.”

The Court of Chancery took a dim view of this argument. Surplus is defined in Section 154 of the DGCL as the excess of net assets (i.e., the amount by which total assets exceed total liabilities) over the amount determined to be capital. The “capital” of a corporation is calculated pursuant to Sections 154 and 244 of the DGCL. If a corporation has only par value stock, its capital typically is equal to the aggregate par value of its issued shares, unless the board of directors has determined that the capital shall be a greater amount. Section 160 of the DGCL prohibits Delaware corporations
from purchasing or redeeming its own shares of stock “when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital stock of the corporation.”3 A stock repurchase or redemption impairs capital if the funds used therefor exceed the amount of the corporation’s surplus.4 To redeem shares in excess of the corporation’s surplus would impair the corporation’s capital and render the corporation “balance-sheet insolvent” under Delaware law.

Vice Chancellor Laster observed that although a corporation cannot be balance-sheet insolvent and meet the requirements of Section 160 of the DGCL, a corporation could have surplus, as such concept is defined by the DGCL, yet be insolvent within the meaning of Delaware law. Under such circumstances, the common law prohibition on redemptions by corporations that are insolvent or would be rendered insolvent by a stock redemption restricts the corporation’s ability to redeem shares of its own stock. A corporation is insolvent under Delaware law when its liabilities exceed its assets or when it is unable to pay its debts as they come due. In its analysis, the Court of Chancery noted that Delaware law has long recognized that “in addition to the strictures of Section 160 … a corporation cannot purchase its own shares of stock when the purchase diminishes the ability of the company to pay its debts, or lessens the security of its creditors.”5 Thus, if a corporation redeemed shares and was thereby rendered insolvent, the redemption would not be in conformance with Delaware law, notwithstanding that the corporation might have legal surplus. This implies a distinction between simply demonstrating surplus (which takes into account total assets) and having “funds legally available” to redeem shares of a corporation’s stock.

SVIP premised its claims on the equivalence of surplus and “funds legally available.” Because the two concepts differ, and because the mere existence of surplus is insufficient to establish conclusively a corporation’s obligation to redeem shares irrespective of whether the corporation has “funds legally available,” the Court rejected SVIP’s claims. In reaching its decision, the Court noted that, where the phrase “funds legally available” is employed, a corporation may only use or expend funds that are available (in the sense of being on hand or readily accessible through sales or borrowing) and capable of being deployed legally without violating Section 160 or other statutory or common law restrictions. The Court’s opinion is clear that even if the redemption provision in ThoughtWorks’ certificate of incorporation did not specifically refer to “funds legally available,” a comparable limitation would nevertheless be implied by law in the sense that a corporation may not be able to redeem shares, even if it has surplus, if such redemption would result in insolvency.

Because SVIP could not show that ThoughtWorks had sufficient “funds legally available” to redeem all of the outstanding shares of preferred stock, the Court of Chancery entered judgment in favor of the Company.

Analysis of the Court’s Decision

Delaware law requires that stock redemptions be made only from a corporation’s surplus. However, from a financial point of view, this case distinguishes surplus from

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3 Del. C. § 160(a)(1).
5 ThoughtWorks, 7 A.3d at 987 (citing In re International Radiator Co., 92 A. 255 (Del. Ch. 1914)).
“funds legally available” in two ways. First, surplus considers a company’s total assets (including working capital, fixed assets, and intangible assets), while “funds legally available” only contemplates a corporation’s cash and cash equivalents (or its ability to raise such cash). Second, while surplus only considers a corporation’s balance sheet solvency, “funds legally available” considers the second test of solvency, a corporation’s ability to pay its debts as they come due.

The potential repercussions should a company redeem stock, and thereafter enter bankruptcy or go out of business altogether, may be harsh. The company and its directors may expect legal action from the remaining stockholders who did not benefit from the redemption, but were left holding an insolvent company after the fact. In addition, the company may be subject to fraudulent conveyance laws, which are designed to prevent secured creditors, stockholders, and others from benefitting financially at the expense of unsecured creditors. Fraudulent conveyance is addressed in Section 548 of the Federal Bankruptcy Code and falls into two categories: intentional fraud and constructive fraud. Section 548(a)(2) of the Federal Bankruptcy Code defines “constructive” fraud as occurring when a debtor has received less than reasonably equivalent value for the transfer made and either: (i) was insolvent on the date such transfer was made or becomes insolvent as a result of such transfer; (ii) retained “unreasonably small assets” or “capital” after the transfer; or (iii) made the transfer with the intent to incur, or reasonably should have believed that it would incur, debts beyond its ability to pay. If a fraudulent conveyance is found to have occurred, a company’s directors could face personal liability and selling stockholders could be forced to return the transaction proceeds, among other penalties.

In light of this decision, company fiduciaries should consider obtaining a solvency opinion (or certain elements thereof) before approving a stock redemption. A solvency opinion is distinct from a traditional “capital adequacy” opinion, which in the past was often the only financial opinion a board would seek in these circumstances. However, a capital adequacy opinion considers only whether, on a pro forma basis (i.e., taking into account the effects of the transaction), a company is balance sheet solvent, and is intended to address the surplus requirement of Section 160 of the DGCL. It is primarily conducted by means of a “balance sheet” test, wherein the fair value of a company’s assets is compared to its liabilities to determine if the net amount is at least equal to the company’s capital.

A solvency opinion, on the other hand, considers not only a company’s balance-sheet solvency, but also its ability to pay its debts as they come due (the “cash flow” test) and the adequacy of its capital to fund ongoing operations (the “reasonable capital” test). The cash flow test considers the company’s projected cash flows and utilizes sensitivity analyses on these projections to determine the “safety margin” available to the company. The reasonable capital test goes beyond a traditional capital adequacy opinion and considers whether a company’s “equity cushion” is too small to provide some level of downside protection if the company’s results don’t meet its projections. If its capital is inadequate, it may be unable to fund its continuing operations in such a downside scenario. A financial advisor may suggest that one or both of these analyses be included in a financial opinion in instances where a company may have significant asset value but little current cash flow – for example, a start-up business with promising technology but minimal revenue or profits, or a homebuilder with an inventory of completed
and in-process homes but depressed current sales. In both of these cases, a company may have surplus under a strict reading of Delaware law, but not have “funds legally available” to distribute to stockholders.

Although one cannot (based on the limited public record) determine whether ThoughtWorks could redeem a greater number of shares, the Company’s failed attempts to raise a sufficient amount of capital to redeem the shares in full are consistent with the type of analysis that a financial advisor would conduct to inform itself of a company’s liquidity. In addition, many commercial lending agreements expressly prohibit a redemption of stock in a manner consistent with the outcome of this case. Lenders may explicitly require a company to maintain liquidity greater than simple surplus in order to buy back shares of its stock or pay a dividend to stockholders.

Conclusion

When undertaking a redemption transaction, a board of directors would be wise to consider all factors affecting the solvency of a corporation, and not just its surplus as defined under the DGCL. This should include its current cash available to fund the redemption, its ability to raise additional cash through the capital markets, and its ability to continue as a going concern following the redemption (i.e., its ability to fund the capital needs of its ongoing operations, such as working capital and fixed asset additions, and its ability to pay its debts as they come due). A financial advisor can assist a board of directors in determining if a redemption will render a company insolvent, based upon all of the factors enunciated by the Court of Chancery in this decision. With the proper information in hand, and with assistance from a financial advisor that is experienced in evaluating a corporation’s solvency from a number of different perspectives, a board can still meet its fiduciary duties under Delaware law and make a properly informed decision as to the legality, and appropriateness, of such a transaction.

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**TASK FORCE REPORTS**

**Task Force on Distressed M&A**

The Task Force on Distressed M&A held a successful meeting at the 2010 Annual Meeting in San Francisco. Jennifer Muller from Houlihan Lokey discussed the pending 2011 Deal Point Study of Sales Under Section 363 of the United States Bankruptcy Code. Peter Fishman, also of Houlihan Lokey, provided an update on the state of the distressed M&A market. Since the San Francisco meeting, we have completed our questionnaires for the 363 Deal Point Study and we are actively recruiting members who are willing to work on the 363 Deal Point Study.

We plan to have a robust discussion on distressed deal making at our meeting on Friday, January 28, from 9:00 a.m. until 10:30 a.m., in the Grand Ballroom at the Ritz-Carlton Hotel in Miami.

Domestic (US and Canada): 866-646-6488
International: 707-287-9583
Conference Code: 1394196854

We will also be discussing the 363 Study and opportunities to become involved.

I hope to see you in Miami.

Hendrik Jordaan
Chair
Task Force on New Projects

The completion, or near completion, of two seminal projects, the Revised Model Stock Purchase Agreement and the Model Merger Agreement, provides the Committee with the luxury of identifying new initiatives. Accordingly, the Committee has formed a new Task Force, cleverly named (for now) the Task Force on New Projects, to identify appropriate initiatives. This Task Force will have its initial meeting in Miami to consider projects that will energize our members, while producing works that will benefit the M&A bar and other deal professionals. All interested members of our Committee are invited and encouraged to attend. The meeting will be held on Friday, January 28, from 11:00 a.m. until 12:30 p.m., in the Grand Ballroom at The Ritz-Carlton Coconut Grove.

A tentative and non-exclusive list of ideas (included to spur your thoughts) to be discussed at the inaugural meeting is set forth below:

- Draft an annotated sell-side two-step acquisition agreement, including ancillary documents such as bid requests (round 1 and 2), engagement letter for investment bankers, and disclaimer page.

- M&A Marketplace – Create an interactive, content focused website that becomes a valuable resource for deal advisors (both legal and financial), with the ultimate goal of enhancing the ability of our members to efficiently deliver quality counsel while driving and maintaining our membership.

- Revised Model Asset Purchase Agreement – Comprehensively revise this work (with seller’s responses similar to the revised Model Stock Purchase Agreement).

- Task Force to consider choice of law/forum ramifications of key M&A agreement terms (e.g., material adverse change, sandbagging, non-reliance, parole evidence, and benefit of the bargain).

- Web-based Programming – This Task Force would provide our members with M&A developments in the most efficient and accessible formats, including podcasts and teleconferences. While our Committee continues to support traditional CLE, the focus of this Task Force would be to provide quick updates on key developments. Periodic brown bag lunches might be a workable approach.

- Task Force to assist in development of programming for young lawyers. In order to keep our Committee vibrant, we must accelerate our efforts at recruiting young attorneys. Many ideas have been offered
  - regularly holding a boot camp the afternoon before our first full day of Committee meetings;
  - sponsoring (or co-sponsoring with Practical Law Company) meetings at the Young Lawyers Committee of the Business Law Section; and
  - work with the ABA to discount fees to young, first time attendees.

- LLC and Partnership Acquisitions – Delaware is now seeing more businesses organized as LLCs and limited partnerships than corporations for entity governance, structure and tax reasons.
An Appendix to the revised Model Stock Purchase Agreement dealing with partnership and LLC interest acquisitions could be a viable project.

- **International Financial Reporting Standards** – Our current versions of Model Merger Agreement and revised Model Stock Purchase Agreement deal with IFRS to a limited extent. We might develop an IFRS supplement to both documents that would be updated from time to time as IFRS evolves. This new project would allow us to meaningfully involve our AICPA colleagues.

- **Ethics for M&A** – We regularly offer ethics panels at ABA meetings and our National Institutes, and might form a Task Force or Subcommittee to more thoroughly develop the emerging developments.

- **Investment Banker Documentation**, including engagement letters for M&A assignments, fairness opinions and dealer-manager agreements for exchange and tender offers.

- **Practical Law Company collaboration** – produce an annotated document based off a core agreement produced by Practical Law Company.

- **Legal Opinions** – This Task Force would prepare, in collaboration with the ABA Legal Opinions Committee, model opinions for asset purchases and merger transactions, similar to the opinion we created to accompany the revised Model Stock Purchase Agreement.

  I look forward to seeing you at our inaugural meeting in Miami.

  Bruce Cheatham
  Chair

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**SUBCOMMITTEE REPORTS**

**Acquisitions of Public Companies Subcommittee**

Have we really not seen each other since early August? So much has happened since then!

Our Model Agreement for a stock for stock merger involving a public company target is now far along in the quality control process. We have held many Editorial Board meetings since August 2010, including a two day session in Palo Alto to work through the entire Model Agreement, and many calls and emails. We are finalizing style comments and have received a handful of comments from Steven Davidoff, which we have discussed and now are implementing. Special thanks to Jim Melville for turning a draft reflecting all of our technical comments, and to Bruce Cheatham for processing all of our style comments. Several members of the Editorial Board have worked long hours and devoted their considerable brain power to making this Model Agreement a work of which we can be proud.

I am hoping that we will be able to release the final Model Agreement, together with the Fact Pattern, Exclusivity Letter, Confidentiality Agreement, and Voting Agreement to the ABA Publications folks either right before or right after our Committee meeting. Of course, our goal will be sales at the April meeting of the ABA Business Law Section in Boston.

So many of us have been wrapped up in that process that we have not yet thought through the best way to commence our sell side auction, two step tender offer agreement. The
Subcommittee leadership will be discussing this at the upcoming meeting in Miami, and we may have an updated proposal at the Subcommittee meeting, or if not then, shortly after. Stay tuned!

I am pleased to report that there will be two wonderful programs at our Subcommittee meeting in Miami. First, Michael O’Bryan, Bruce Cheatham, and Rick Alexander will present a panel discussion on “Dealing with Derivatives and Wolfpacks in Drafting Poison Pills.” That will be a teaser of sorts for our Committee Forum the next day, where I will be joined by the Honorable Myron T. Steele, Chief Justice of the Delaware Supreme Court, and Gregory V. Varallo in a program, “Take a Pill and Call me in the Morning – Lessons Learned from Selectica and Other Recent Rights Plan Cases.” Our second program at the Subcommittee will be a mock negotiation of the termination provisions in the Model Agreement! Arrayed on one side of our negotiating table will be Ed Deibert and C. Stephen Bigler, representing Target. On the other side will be Jim Griffin and Mark Morton. As you can see, a titanic struggle will ensue. Be sure to come root your side on!

Our tradition has been to forego our Task Force dinner at stand-alone Committee meetings since, as you know, there are two Committee dinners scheduled. I will, however, be arriving on Thursday and I am always up for a dinner with good friends! Let me know if you want to try to organize a dinner that evening and if you have a good dinner place to suggest near our hotel. You can reach me at diane.frankle@dlapiper.com.

Jim Griffin, Lorna Telfer and I look forward to seeing many of you in sunny [we hope] and warm [ditto!] Miami!

Diane Holt Frankle  
Chair  
Jim Griffin  
Lorna Telfer  
Vice Chairs

**International M&A Subcommittee**

The International M&A Subcommittee met on Sunday, August 8, 2010, in connection with the Annual Meeting of the ABA at the Fairmont Hotel in San Francisco.

**Using Bilateral Investment Treaties to Protect Your Commercial M&A Client**

Bill Knull gave a presentation on using bilateral investment treaties to protect commercial M&A clients, which was followed by a Q&A session.

**Public Company Takeovers Project**

Daniel Rosenberg summarized the current state of play on the Subcommittee’s International Public Company Acquisitions Project. This had been progressed to the point of an advanced stage questionnaire during the period 2000 to 2003 but had been put on hold pending the completion of the Model Merger Agreement project by the Acquisitions of Public Companies Subcommittee. Daniel has advanced this with Franziska Ruf (who is also a member of the Acquisitions of Public Companies Subcommittee) and has an initial list of the appropriate jurisdictions and contributors for our project.

**International JV Agreement Project**

Daniel Rosenberg also reported, on behalf of Freek Jonkhart and Mireille Fontaine, on the Subcommittee’s International JV project.
Many of the responses to the project questionnaire that have been received are longer than 30 pages, which it was agreed was longer than ideal. This was as a result of the original questionnaire being lengthy and Freek and Mireille have now shortened it. It was agreed that this shortening should not be at the expense of the IP section, given the importance of IP to many JVs. Reid Feldman suggested shortening the work by taking areas where there were common answers (e.g., some European jurisdictions) and to have a single response with as much common ground as possible, which would allow the individual country responses to deal with just the deviations from that. Daniel also called for volunteers for the project’s editorial board and a number of volunteers came forward after the meeting.

**Foreign Direct Investment Laws Project**

Frank Picciola summarized the current status of the Subcommittee’s Foreign Direct Investment Laws project and called for volunteers to cover a number of jurisdictions for which input is still needed. It was noted that the responses to date would be published shortly on the Subcommittee’s website.

**Dealing with Confidential Employee Information in M&A Due Diligence**

Nick Dietrich summarized the Canadian issues that arise when dealing with confidential employee information in M&A due diligence in the light of the Canadian Personal Information Protection and Electronic Documents Act 2000 and led a discussion on similar issues around the world, in which Stephan Göthel and Daniel Rosenberg summarized the positions in Germany and the UK, respectively.

**Post-Closing Dispute Resolution Program and Project**

Katrien Vorlat first described the program “What if International M&A Deals Go Sour - Lessons to be Learned for Drafting Dispute Resolution Clauses,” which the Subcommittee had presented on Friday morning. Daniel Rosenberg thanked Katrien for chairing the program and her speakers Jean-Pierre Fierens, Vladimir Khvalei, William Knull, and Alfredo Rovira for their excellent presentations, noting that the panel had been well attended and of high quality.

Katrien also summarized the status of the Subcommittee’s Post-Closing Dispute Resolution project. The results of this project will be published on the Subcommittee’s website.

**Programs and Projects**

More generally, it was noted that there were a range of possible formats for programs and presentations, from short presentations (e.g., 15 minutes) at a Subcommittee meeting to full two-hour programs accredited for CLE. The following subjects were proposed as possible topics for future programs or subcommittee discussion topics:

- John Elder offered to speak on the Canadian position on a presentation or program on IFRS.
- David Spence suggested a presentation or program on share stakebuilding, including disclosure obligations. Guy Harles suggested extending this beyond just public companies, for example to disclosure obligations on private equity funds in Europe.
- Katrien Vorlat suggested a presentation or program on employment law impacts on M&A transactions before, during, and after a deal is done (a topic originally proposed at an earlier meeting by Joe Stegbauer of Procter & Gamble).

Other suggestions remaining on the agenda from earlier meetings are as follows:
• Use of New Supranational Corporate Entities in M&A (Societas Europas, etc.).

• Mock Negotiation of Cross-Border Acquisition (using results of International Market Trends study).

• Cross-border distressed company acquisitions.

• Return of nationalization risk in cross-border M&A.

• Impacts and risks of privacy regimes in the EU and elsewhere.

• Director liability issues after the deal is done: You’re not in Kansas (London, Toronto) any more.

• FCPA/anticorruption law compliance: How to assess the risks before committing to a transaction and how to fix what you bought.

• Off-shore Holding Company Structures for M&A.

Current Developments Discussion

The meeting concluded with our customary general discussion by Subcommittee members regarding legal developments in their jurisdictions relevant to M&A practice. Points raised included the following:

• Jim Doub updated the meeting on the new Iran Sanctions legislation in the US, which could be relevant to cross-border deals.

• Daniel Rosenberg updated the meeting on the UK’s Bribery Act 2010. The expected timetable is currently for a consultation to be conducted in September 2010, with guidance expected to be issued in January 2011 and the Act expected to come into force in April 2011.

Subcommittee Website

The Subcommittee’s website can be found at the following address:

www.abanet.org/dch/committee.cfm?com=CL560016

The Subcommittee’s website contains the following information:

• The slides from the presentation to the Subcommittee on “Using Bilateral Investment Treaties to Protect Your Commercial M&A Client.”

• The materials from the Subcommittee’s program “What if International M&A Deals Go Sour - Lessons to be Learned for Drafting Dispute Resolution Clauses.”

• Presentation notes of Nick Dietrich and colleagues on the Canadian issues when dealing with confidential employee information in M&A due diligence.

• Notes prepared by Jim Doub on the new Iran Sanctions legislation in the US.

• The latest materials from the Subcommittee’s Foreign Direct Investment Project and International Dispute Resolution Project.

• Details of the Subcommittee’s publications, future meetings, other work-in-progress, and other past program materials.

We look forward to seeing you in Miami.

Daniel P. Rosenberg
James R. Walther
Co-Chairs
Membership Subcommittee

A quick overview of where we are in terms of membership numbers since July 15, 2010:

Our total Committee membership is at 4,054 compared to a 3,682 membership as of July 15, 2010 – a 10% increase!

Our membership is still throughout 49 states, but went up from 47 to 49 countries. Our in-house counsel members have also grown from 377 to 391, while our “associate” members (non-lawyers) are now at 330 from 305 – an increase of 8%. This demonstrates we have been keeping our energy focused on those “associate” members.

Indeed, the Membership Subcommittee has recently assisted the ABA Business Law Section in a formal expansion of ties with the Association for Corporate Growth (ACG), including efforts to create synergies and cross-sell our knowledge, contacts, and meeting opportunities. This effort is ongoing. We were present at the Intergrowth event held in May of last year in Miami and the response has been very good. ACG will therefore be a program partner for the second time at our Spring meeting in Boston. Members of the ACG will be eligible to register at the Section member meeting rate (and registration for the meeting will be even less if a first time attendee). Needless to say we welcome members of the ACG Boston Chapter to attend our programming!

The M&A Market Trends Subcommittee is still our largest group with 1,471 members. Here is a list of our other subcommittees with the largest membership numbers:

<table>
<thead>
<tr>
<th>Sub委员会</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Equity M&amp;A</td>
<td>1,266</td>
</tr>
<tr>
<td>International M&amp;A</td>
<td>883</td>
</tr>
<tr>
<td>Acquisitions of Public Companies</td>
<td>803</td>
</tr>
<tr>
<td>M&amp;A Jurisprudence</td>
<td>681</td>
</tr>
</tbody>
</table>

It should be noted that these subcommittees have seen their membership grow. Worth mentioning and applauding is the 13% increase in the International M&A Subcommittee. The continued systematic growth of at least 6% for each subcommittee clearly demonstrates we attract new members with our new trends, projects, and continued updates in the various fields. Keep up the good work!

Women continue to represent 17% of the total membership of the Committee but there was a 7% increase! Our Committee is dedicated to seeing this number continue to grow.

Please invite new people to join our Committee. We thank you for your involvement and recruitment efforts. If you see a need or have an idea, please do not hesitate to contact any of us.

Mireille Fontaine
Ryan Thomas
Tracy Washburn
Co-Chairs

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 and
reports to the Committee on 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 work product of the Judicial Interpretations Working Group consists of memoranda summarizing our findings regarding these acquisition agreement provisions and M&A issues. The memoranda are posted in an extranet library, to which only M&A Jurisprudence Subcommittee members have access currently, but which we are preparing to make available to all members of our Committee.

The Annual Survey Working Group will meet in Miami on Friday, January 28, from 8:30 a.m. until 9:30 a.m., in the Verdi Room at the Ritz-Carlton Hotel. The Judicial Interpretations Working Group will meet immediately thereafter, from 9:30 a.m. until 11:00 a.m., in the same room. Dial-in information for the meetings will be sent to members of the Subcommittee.

**Annual Survey Working Group**

The eighth Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions will be published in the February 2011 issue of *The Business Lawyer*. We thank all Committee members who participated in that effort. At the Committee meeting in Miami we will discuss the *Aveta* decision, which is summarized below. At the Working Group meeting we will begin our efforts to select cases for inclusion in the 2011 annual survey.

We are asking all members of our Committee to send us significant judicial decisions for possible inclusion in the survey. Submissions can be sent by email either to Jon Hirschoff at jhirshoff@fdh.com or to Mike O’Bryan at mobryan@mofo.com. You may fax cases to Jon at (203) 325-5001 or to Mike at (415) 268-7522. 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 (a) 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), (b) 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), (c) pertain to a successor liability issue, or (d) 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.

To join our working group, please email Jon Hirschoff at jhirshoff@fdh.com with a copy to Mike O’Bryan at mobryan@mofo.com or simply attend the working group meeting in Miami.
Decision to be Discussed at the Miami Committee Meeting


In Aveta Inc. v. Cavallieri,\(^1\) the Delaware Court of Chancery found that the contractual process provided in a merger agreement for determining post-closing adjustments to the purchase price payable to target shareholders was binding on all shareholders of the target, including shareholders that neither signed the merger agreement nor voted in favor of the merger.

Background

In 2006, Aveta Inc., a Delaware corporation (“Aveta”), acquired Preferred Medicare Choice, Inc. (“PMC”), a Puerto Rico corporation, in a two-step transaction pursuant to a stock purchase and merger agreement entered into by Aveta, PMC, and PMC’s controlling shareholders.\(^2\) The merger agreement was governed by Delaware law. PMC’s capital structure consisted of Class A and Class B shares, with Class A shares comprising 51% of PMC’s outstanding shares and Class B shares comprising the remaining 49%. The Class A shares were owned by four controlling shareholders, including Roberto Bengoa (“Bengoa”), who was designated in the merger agreement as the “Shareholders Representative” for all PMC shareholders. The Class B shares were owned by over 100 individuals, many of whom were health care professionals in PMC’s provider network.\(^3\)

Aveta commenced the deal through the purchase of the Class A shares for 60.93% of the transaction consideration. Thereafter Aveta merged an acquisition sub into PMC, and PMC became a wholly-owned subsidiary of Aveta and the Class B shares were converted into the right to receive the remaining 39.07% of the transaction consideration. The Class B shareholders neither signed the merger agreement nor were asked to vote on the transaction because the Class A shareholders held a majority of the voting power and thus could approve the merger.\(^4\)

The transaction consideration was subject to earn-out payments, working capital adjustments, and claims related to PMC’s liabilities incurred but not recorded at closing (collectively “Post-Closing Adjustments”). Aveta was required to calculate the Post-Closing Adjustments based on PMC’s books and records and reach an agreement with the Shareholders Representative regarding its calculations; if Aveta and Bengoa could not agree, the merger agreement provided that their dispute would be resolved through binding arbitration.\(^5\)

After the closing, Aveta and Bengoa tried, but failed, to agree on the Post-Closing Adjustments. Aveta commenced arbitration. Concurrently, a group of former Class B shareholders “purported to revoke Bengoa’s designation as Shareholders Representative and claimed that he had no authority to represent them.”\(^6\) Additionally, another group of former PMC shareholders filed a lawsuit in Puerto Rico that challenged Aveta’s calculation of the Post-Closing Adjustments.\(^7\) In response, Aveta filed an action to determine “whether the

\(^{1}\) C.A. No. 5074-VCL (Del. Ch. Sept. 20, 2010).

\(^{2}\) Id. at 2.

\(^{3}\) Id. at 2 - 4.

\(^{4}\) Id. at 2.

\(^{5}\) Id. at 1, 5.

\(^{6}\) Id. at 8.

\(^{7}\) Id. at 8 - 10.
contractual process for calculating the
consideration, including the outcome of the …
arbitration, binds all former PMC
shareholders.”

**Controlling Class A Shareholders**

The Court held that the controlling
shareholders were bound by the Shareholder
Representative’s actions because, under
Delaware law, they irrevocably appointed the
Shareholders Representative as their agent in
the merger agreement that each of them signed.
The Court noted that, pursuant to the General
Corporation Law of the State of Delaware (the
“DGCL”), a grant of authority will be upheld as
irrevocable when it is “coupled with an interest” and defined an interest as “authority
over the subject matter of the agency that exists
independent of the agency relationship.”

Bengoa’s status as a Class A shareholder
entitled him to a portion of the transaction
consideration independent of his authority as
Shareholders Representative, and as a result, it
was “coupled with an interest sufficient to make
it irrevocable.”

The Court also pointed to the
“interrelated provisions” of the merger
agreement, noting that Bengoa’s authority as
Shareholders Representative “implicated
Aveta’s reliance interests.”

**Minority Class B Shareholders**

The Court held that the Class B
shareholders were bound by the actions of the
Shareholders Representative as a matter of
corporate law. The Court explained that the
merger was governed by Section 3051 of the
Puerto Rico General Corporation Law, which
paralleled Section 251 of the DGCL as it
existed in 1995. Section 3051 stated that “terms
of the merger agreement may depend upon facts
ascertainable outside the merger agreement;
provided that the manner in which such facts
shall affect the terms of the merger agreement
is clearly and expressly set forth in the merger
agreement.”

The Court reasoned that the Post-
Closing Adjustments “easily qualify as
provisions dependent on facts ascertainable
outside of the merger agreement,” because the
requisite calculations are clearly set forth in the
merger agreement and based on PMC’s books
and records. Consequently, agency authority
was not needed to bind the Class B
shareholders because the merger agreement
provided for the determination of the Post-
Closing Adjustments in accordance with
Section 3051. Moreover, the outcome binds
all Class B shareholders, because the Class B
shares were converted into rights to receive
the transaction consideration as determined by
the merger agreement.

The Court also noted that Delaware had
amended Section 251 in 1996 to provide more
specifically that “[t]he term ‘facts,’ as used in
the preceding sentence, includes … the
occurrence of any event, including a
determination or action by any person or body,
including the corporation.” The Court stated
that such language would have made it “readily
apparent” that Aveta’s calculation of the Post-
Closing Adjustment, Aveta’s and the
Shareholders Representative’s agreement on the
calculations, and the outcome of any arbitration

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8 *Id.* at 1.
9 *Id.* at 13.
10 *Id.* at 14.
11 *Id.* at 15 - 16.
12 *Id.* at 18.
13 *Id.* at 30.
14 *Id.* at 31.
15 *Id.* at 25, 27.
all were “facts ascertainable outside the agreement.” Nevertheless, the Court reviewed the history of Section 251 and found that, even without the amendment, Section 251 was intended to support calculations of the type made by the Shareholders Representative. The Court further stated that such calculations did not constitute an “improper abdication” or other “breach of fiduciary duty” as had potentially been the case in other challenged transactions.

The Model Business Corporation Act

While not relied on by the Court in this decision, Section 1.20(k) of the Model Business Corporation Act operates similarly to Section 251 of the DGCL. The material difference between both provisions is that Section 1.20(k) requires a corporation to file articles of amendment when a fact becomes ascertainable if a provision is made dependent on a fact not ascertainable by reference to (i) statistical or market indices, market prices of any security or group of securities, interest rates, currency exchange rates, or similar economic or financial data, or (ii) a document that is a matter of public record, or the affected shareholders have not received notice of the fact from the corporation.

Judicial Interpretations Working Group

The primary project of the Judicial Interpretations Working Group is to create for members of our Committee an on-line research library of memos on acquisition agreement provisions and M&A issues. Our goal is to launch the library in 2011, with memoranda summarizing the judicial interpretation of the following: (i) financial statement representations; (ii) no undisclosed liabilities representations; (iii) full disclosure (“10b-5”) representations; (iv) material adverse change clauses; (v) survival clauses and contractual statutes of limitations; (vi) tortious interference claims in M&A transactions; (vii) attorney-client privilege and conflicts issues in M&A transactions; (viii) best efforts/reasonable efforts clauses; (ix) earn-out provisions; (x) exclusivity and standstill provisions or agreements; (xi) choice of law provisions; (xii) bringdown conditions; (xiii) no third-party beneficiaries provisions; (xiv) non-reliance provisions; (xv) rescission claims based on fraud when indemnification is stated to be sole remedy; and (xvi) dispute resolution clauses in purchase price adjustment provisions.

We have working group teams in various stages of preparation of memoranda regarding additional acquisition agreement provisions and M&A issues, and we have a virtually unlimited pool of topics to work on in the future. We welcome all interested Committee members to join our Working Group. The Judicial Interpretations Working Group is a good way to become involved in the Committee, especially for younger Committee members, because extensive M&A transactional experience is not necessary.

The Judicial Interpretations Working Group met during the ABA annual meeting in San Francisco. During the meeting we had a spirited discussion of the memo on no third-party beneficiary provisions authored by Frederic Smith, and the memo on bring-down conditions authored by Brian North. We also discussed the revision of Arthur Wright’s paper on earnouts that we originally reviewed at the Spring meeting in Denver.

As indicated above, the Miami meeting of the Judicial Interpretations Working Group will be held on Friday, January 28, from 9:30 a.m. until 11:00 a.m., in the Verdi Room of the Ritz-Carlton Hotel, immediately following the

\[16\] Id. at 19.
\[17\] Id. at 29 - 30.
\[18\] Id. at 31.
Annual Survey Working Group meeting. We plan to discuss the following: the memo on non-reliance provisions authored by Joe Kubarek and Pat Leddy; the memo on dispute resolution clauses in purchase price adjustment provisions authored by Alan Sachs; and Nick Dietrich’s paper on rescission claims based on fraud when indemnification is stated to be the sole remedy. We will also discuss some of the other memoranda in progress, and our plans for the architecture and functionality of the internet library.

To join our working group, please send an email to Scott Whittaker at swhittaker@stonepigman.com and Jim Melville at jcm@kskpa.com, or simply attend the working group meeting in Miami.

Jon T. Hirshoff  
Subcommittee Chair

Michael G. O’Bryan  
Chair - Annual Survey Working Group

Scott T. Whittaker  
James C. Melville  
Co-Chairs - Judicial Interpretations Working Group

M&A Market Trends Subcommittee

Happy New Year! 2010 was a very busy year for the members of the M&A Market Trends Subcommittee, with the publication of three separate deal point studies. Kudos to each of the Chairs and Working Groups on the publication of the 2010 Strategic Buyer/Public Company Target M&A Deal Points Study (chaired by Hal Leibowitz), the 2010 Canadian Private Target M&A Deal Points Study (chaired by John Clifford), and the 2010 European Private Target M&A Deal Points Study (chaired by Reid Feldman and Freek Jonkhart).

Some trends and highlights from each of these studies:

**2010 Strategic Buyer/Public Company Target M&A Deal Points Study**

- The 2010 Public Target Study demonstrated the continuation of a number of interesting trends. The “Fair Representation” financial statements representation, for example, continues the trend away from inclusion of a GAAP qualification – only 11% of the Fair Representation representations in the 2010 Public Target Study were GAAP-qualified, down from 27% in the 2008 Public Target Study and 22% in the 2009 Public Target Study.

- Similarly, the trend continues toward inclusion of a closing condition that there be no governmental litigation challenging the transaction – 63% of the deals in the 2010 Public Target Study included such a condition, up from 54% in the 2008 Public Target Study and 44% in the 2009 Public Target Study.

- Additionally, the march toward Delaware governing law continued. In the 2010 Public Target Study, 100% of the deals involving a Delaware target chose Delaware law (up from 92% in the 2008 Public Target Study and 95% in the 2009 Public Target Study). Perhaps more interestingly, 71% of non-Delaware targets in the 2010 Public Target Study chose Delaware law to govern the interpretation of their agreements (up from 28% in the 2008 Public Target Study and 36% in the 2009 Public Target Study).
2010 Canadian Private Target M&A Deal Points Study

- Earn-outs are rarely a feature of Canadian deals.

- 19% of the deals in the 2010 Canadian Study did not include a compliance with law representation (down from 33% in the 2008 Canadian Study).

- Double-materiality carve-outs in the bring-down relating to the accuracy of representations appeared in only 24% of deals in the 2010 Canadian Study, compared to 84% in the 2009 US Private Target Study.

- Indemnification survival periods in Canada tend to be longer than in the US. The 2009 US Private Target Study reported that the predominant survival periods for reps and warranties were 12 months (20%), 18 months (38%), and 24 months (17%). The 2010 Canadian Study reports that only 18% of deals had 12-month survival periods, 14% had 18-month periods, 31% had 24-month periods, and 16% had more than 24 months.

- A similar result is reported for indemnity caps. The indemnity cap was the purchase price in 45% of the deals in the 2010 Canadian Study, whereas in the 2009 US Private Target Study the cap was 50% of the purchase price or less in 91% of reported deals.

2010 European Private Target M&A Deal Points Study

- The 2010 European Study highlights again some significant differences between M&A practices in Europe compared with the US. Only 47% of the deals in the 2010 European Study included a Material Adverse Change (MAC) condition (whether of the stand-alone or back-door variety), while in the 2009 US Private Target Study 98% included a form of a MAC condition.

- Other differences with US practice included significantly fewer instances of certain representations. 97% of deals in the 2009 US Private Target Study, for example, included a “no undisclosed liabilities” representation as compared to 40% in the 2010 European Study. In addition, pro-sandbagging (or “benefit of the bargain”) provisions were found in only 7% of deals in the 2010 European Study as compared to 39% in the 2009 US Private Target Study.

- There was no change in the number of deals that were subject to dispute resolution by arbitration and this remains a contrast with the US study (71% of deals in the 2010 European Study were subject to arbitration in contrast to 33% in the 2009 US Private Target Study).

As is our practice, these newly published studies (and all prior studies) are available for complimentary download by members of our Committee at the following address:

http://www.abanet.org/dch/committee.cfm?com=CL560003

One other significant development – for the first time (that we know of), one of our Deal Point studies – the 2009 Public Target Study – was cited as authority in an opinion issued by the Delaware Court of Chancery. See In Re Cogent, Inc. Shareholder Litigation, 7 A.3d 487, 505 n.56 (Del. Ch. 2010).
Our meeting in San Francisco in August was well attended (some would say too well attended – we’ve arranged for more space at future meetings). At that meeting, we conducted the following business: Reid Feldman previewed selected data points from the 2010 European Study; John Clifford previewed selected data points from the 2010 Canadian Study; Hal Leibowitz previewed selected data points related to two-step transactions from the 2010 Public Target Study; Mark Morton discussed trends in Delaware litigation involving two-step deals; and Jennifer Muller of Houlihan Lokey updated the Subcommittee on the state of the M&A market.

Our next meeting is in Miami on Saturday, January 29, from 9:00 a.m. until 10:30 a.m. At that meeting, we will hear from the following:

- Jennifer Muller on updated data on the state of the M&A market;
- Mark Morton on the latest in Delaware case law developments, including additional developments in top-up litigation;
- John Clifford on selected data points in the now published 2010 Canadian Study; and
- Hal Leibowitz on selected data points in the now published 2010 Public Target Study.

In addition, we will hear from Jay Bothwick on the long-awaited (and much anticipated) return of the Private Equity Buyer/Public Company Target M&A Deal Points Study. Jay will be Chairing that project this year. This study will test deal points in transactions from 2007 through 2010, and compare them to what we saw in the study looking at 2005-2006 agreements. We expect to release this study in 2011. So, for those who are interested in getting involved in the M&A Market Trends Subcommittee, this is an excellent opportunity.

The dial-in number and passcode for the meeting for those of you who cannot attend in person is as follows:

Domestic (US and Canada): 866-646-6488
International: 707-287-9583
Passcode: 1394196854

We look forward to seeing you in (hopefully) warm and sunny Miami.

Jim Griffin
Jessica Pearlman
Co-Chairs

Private Equity M&A Subcommittee

The Private Equity M&A Subcommittee did not gather in San Francisco in August 2010 in conjunction with the ABA’s Annual Meeting.

The Subcommittee will next gather in conjunction with the upcoming stand-alone meeting of our Committee, which will occur January 28 and 29 in Miami. At that time, the Subcommittee will be joined by senior representatives of Citigroup Global Markets, Churchill Financial, and GF Data Resources to review and discuss the latest trends and developments in the Private Equity market.

John K. Hughes
Chair

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COMMITTEE MEETING MATERIALS

COMMITTEE ON Mergers & Acquisitions
THE RITZ-CARLTON,
COCONUT GROVE
JANUARY 28-29, 2011

SCHEDULE OF MEETINGS AND OTHER ACTIVITIES

Friday, January 28, 2011
Meeting Registration
8:00 a.m. – 5:00 p.m.
Ballroom Foyer

Continental Breakfast
8:00 a.m. – 10:00 a.m.
Puccini/Vivaldi

Annual Survey Working Group of the M&A Jurisprudence Subcommittee
8:30 a.m. – 9:30 a.m.
Verdi Room

Task Force on Distressed M&A
9:00 a.m. – 10:30 a.m.
Grand Ballroom

Judicial Interpretations Working Group of the M&A Jurisprudence Subcommittee
9:30 a.m. – 11:00 a.m.
Verdi Room

Task Force on New Projects
11:00 a.m. – 12:30 p.m.
Grand Ballroom

Buffet Lunch (ticket required)
12:00 p.m. – 1:30 p.m.
Fountain Courtyard

Private Equity M&A Subcommittee
12:30 p.m. – 2:30 p.m.
Grand Ballroom

Acquisitions of Public Companies Subcommittee
2:30 p.m. – 4:30 p.m.
Grand Ballroom

Meeting of Committee Chair and Vice Chairs, Subcommittee and Task Force Chairs
4:30 p.m. – 5:30 p.m.
Verdi Room

Committee Reception and Dinner (ticket required)
Motor Coach Departs: 6:30 p.m.
Reception: 7:00 p.m.
Dinner: 8:00 p.m.
Orantique on the Mile – Coconut Grove
278 Miracle Mile
Coral Gables, FL 33134
305-446-7710
Sponsored by Appleby

Saturday, January 29, 2011
Meeting Registration
8:00 a.m. – 5:00 p.m.
Ballroom Foyer

Continental Breakfast
8:00 a.m. – 10:00 a.m.
Puccini/Vivaldi

Task Force on Dictionary of M&A Terms
8:30 a.m. – 9:30 a.m.
Verdi Room

Task Force on Dictionary of M&A Terms
8:30 a.m. – 9:30 a.m.
Verdi Room

M&A Market Trends Subcommittee
9:00 a.m. – 10:30 a.m.
Grand Ballroom

International M&A Subcommittee
10:30 a.m. – 12:30 p.m.
Grand Ballroom
Buffet Luncheon (ticket required)
12:00 p.m. – 1:00 p.m.
Botticelli Terrace

Full Committee Meeting
1:00 p.m. – 3:30 p.m.
Grand Ballroom

Committee Forum – “Take a Pill and Call Me in the Morning – Lessons Learned from Selectica and Other Recent Rights Plan Cases.” Panelists: The Honorable Myron T. Steele, Chief Justice of Delaware Supreme Court; Gregory Varallo; and Diane Holt Frankle
3:30 p.m. – 4:30 p.m.
Grand Ballroom

Committee Reception and Dinner
Motor Coach Departs: 6:00 p.m.
Reception: 6:30 p.m.
Dinner: 7:30 p.m.
Blue Door at Delano – South Beach
1685 Collins Avenue
Miami Beach, FL 33139
305-674-6400
Sponsored by Merrill Datasite

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