

ASPATORE THOUGHT LEADERSHIP

Mergers and Acquisitions Law 2010

*Top Lawyers on Trends and Key Strategies
for the Upcoming Year*



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The Need for Carefully
Tailored M&A Strategies
in an Economic Downturn

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ASPATORE

Material Developments in M&A Law and Trends to Look for in the Near Future

Given the global financial meltdown that began in 2008, the deal climate in 2009 was markedly different from in prior years, despite the recovery that gained steam over the summer. While credit markets are improving, the markets have not thawed completely and the terms to obtain credit (whether from commercial banks or from private equity investors) remain stringent. Because of these macroeconomic changes, deal lawyers have become more creative in structuring acquisitions. This chapter looks at some of the material and recent changes in mergers and acquisitions (M&A) law and trends to look for in the near future. For example, earn-out structures (using a variety of metrics such as working capital, earnings, and debt levels) have become more prevalent, and this trend is expected to continue. Looking ahead and given the difficult economic environment, transactions in an insolvency setting will pose special challenges in terms of corporate governance and deal structure.

As discussed below, significant case law developments have altered the deal landscape. For example, in the wake of *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), which is discussed below, material adverse effect qualifiers are being drafted in a much more specific manner with regard to general economic and industry-specific changes. Similarly, much more focus has been placed on defining the respective obligations of the parties to an acquisition agreement and clarifying what “reasonable efforts” require of them.

The common thread in M&A deals is risk allocation—this has not changed. Both buyers and sellers are acting cautiously—sellers require deal certainty, and buyers need assurances that the target will not suffer material adverse changes—which we believe is a positive development. Further, to the extent that the *Hexion* decision requires ongoing communications between the parties to avoid a breach of the agreement due to the unilateral action of one party, the purchaser and seller have encouragement to work together to resolve issues and ultimately consummate the transaction, as opposed to subsequently litigating its collapse.

Notwithstanding the changes described above, our overall strategy in the acquisition environment has not changed—that is, to assist senior

management and board members in evaluating the transaction, and negotiating and drafting a deal as specifically as possible, taking into consideration potential macroeconomic and industry-specific changes that may be unforeseen at the initial stages of deal evaluation. It is only the mechanisms by which we seek to achieve the goals of our corporate clients that have been revised. The particular changes we have previously made and are in the process of implementing are discussed below.

Key Cases in M&A Law

In our opinion, the following recent cases have had the most significant impact on M&A law for the reasons set forth below:

Impact of *Huntsman v. Hexion*

Communication

As discussed below, when Hexion became concerned about the potential solvency of the target company, it unilaterally took actions that severely hampered the likelihood that the deal could be financed. However, under the terms of the merger agreement, Hexion was required to undertake its “reasonable best efforts” to obtain financing. Therefore, *Hexion* is extremely relevant for its specific examination of the “reasonable best efforts” standard.

In *Hexion*, Hexion Specialty Chemicals, and its ultimate controlling shareholder, Apollo Global Management, entered into a merger agreement with Huntsman Corporation, the target company, that had no financing contingency and no condition precedent that the merged companies be solvent following the merger. *Id.* at 721. Hexion was required to use its “reasonable best efforts” to obtain financing. *Id.* at 724. However, once Hexion became aware that, due to negative financial quarterly results by Huntsman, it was possible that the merged companies might be technically insolvent, instead of discussing the issue with Huntsman, it had its own financial consultants issue an “insolvency opinion,” which it then sent to the banks that had provided a commitment to provide financing, published the opinion abroad, and then filed a lawsuit for a declaratory judgment excusing it from performance of the merger agreement. *Id.* at 726–730.

Hexion relied upon a provision allowing it to terminate in the event of a “company material adverse effect” (discussed below). *Id.*

In response to Hexion’s request for declaratory judgment indicating it had no further contractual obligations to Huntsman, the court instead held that “to the extent that an act was both commercially reasonable and advisable to enhance the likelihood of consummation of the financing, the onus was on Hexion to take that act. To the extent that Hexion deliberately chose not to act, but instead pursued another path designed to *avoid* the consummation of the financing, Hexion knowingly and intentionally breached this covenant.” *Id.* at 749 (emphasis in original). The court held that a “reasonable response” to the fears of potential insolvency would have been for Hexion to “approach Huntsman’s management to discuss the issue and potential resolutions of it.” *Id.* at 750. Instead, Hexion expressly barred its financial consultants from communicating with Huntsman to request further information while drafting the insolvency opinion. *Id.* at 730. While Hexion’s failure to discuss the issue with Huntsman’s management immediately after the concerns about solvency arose was considered a potential breach, the court indicated that after the “insolvency opinion” was obtained by Hexion, “Hexion had an absolute obligation to notify Huntsman of this concern.” *Id.* at 750. Its failure *alone* to discuss the potential issues with Huntsman “would be sufficient to find that Hexion had knowingly and intentionally breached its covenants under the merger agreement.” *Id.* at 750–751. By proceeding to deliberately scuttle the financing by sharing its insolvency opinion and filing the lawsuit, Hexion merely compounded the existing breach. *Id.* at 751.

Therefore, Hexion’s failure to approach Huntsman’s management to explain its concerns and develop an appropriate course of action resulted in the court’s conclusion that Hexion knowingly and intentionally breached its covenants in the merger agreement. The lesson to be learned is that when problems arise in a deal, it is crucial to communicate them to the other party and attempt to negotiate a solution to the extent feasible. In fact, it is an absolute obligation where the problems could potentially threaten the transaction. Thus, in most situations, we would avoid advising clients to take unilateral action in the face of changed circumstances.

Material Adverse Effect

As in many acquisition agreements, the merger agreement in *Hexion* specifically disclaimed any representation or warranty with respect to prospects, forecasts, or other future events. *Id.* at 741. In light of this type of provision, the court utilized a long-term perspective regarding earning power to determine if there was a material adverse change in the target's business and concluded that there had been no long-term impact on the target's business. *Id.* at 742–743. In reaching this conclusion, the court pointed out that the buyer could have asked for a warranty of short-term forecasts or a lower purchase price with some type of earn-out component. *Id.* at 741. From the buyer's perspective, deal lawyers should consider these types of provisions if important to the buyer's financial model.

Based upon market conditions, we believe the definition of a “material adverse effect” that entitles a purchaser to terminate the agreement needs to be more detailed, because, as in *Hexion*, a purchaser may try to end a transaction based primarily upon market conditions, as opposed to a condition that is unique to the target company and specifically tailored to a transaction. The *Hexion* material adverse effect provision expressly carved out general market conditions as follows: “in no event shall any of the following constitute a Company Material Adverse Effect: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions... (B) any occurrence, condition, change, event or effect that affects the chemical industry generally...” *Id.* at 736–737. We subsequently discuss a provision we recently utilized regarding “material adverse effect,” and believe that, in the current unsettled conditions, it is essential to carefully articulate what constitutes a material adverse effect, both for the seller and for the buyer.

Walk Rights

As previously discussed, the merger agreement at issue in *Hexion* did not contain a financing contingency (other than a covenant to use reasonable best efforts to obtain financing) or a solvency requirement. *Id.* at 721. Instead, the merger agreement contained a provision stating that if Hexion failed to acquire financing (or breached the agreement in various other specified ways), it would be subject to a \$325 million liquidated damages

provision. *Id.* at 724. Going forward, great care should be taken in negotiating these types of provisions. While sellers may push back and require “best efforts” standards with regard to the buyer’s performance obligations (as opposed to “commercially reasonable standards”), buyers should explore different financial models from the onset to determine the parameters of price adjustments if certain metrics are not satisfied, particularly if it is anticipated that the transaction will not be consummated shortly after the execution of the acquisition agreement (allowing more time for a material change in the circumstances surrounding the transaction). By failing to provide for a financing contingency and similar termination rights, Hexion put itself in an untenable position.

Burden of Proof

Another important issue in *Hexion* was which party had the burden to prove the occurrence of a material adverse effect. The court held that “absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract.” *Id.* at 739. It further notes that “commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement.” *Id.* at 738. A “short-term hiccup in earnings” is insufficient to constitute a material adverse effect; instead, “poor earnings results must be expected to persist significantly into the future.” *Id.* Consequently, it is clear that inserting a termination right based solely on a material adverse effect is not a wise drafting decision, as courts construe such a right very narrowly. Any event that would significantly endanger the consummation of the transaction should be addressed in the merger agreement expressly and be associated with a specific termination right.

Impact of Lyondell v. Ryan

In *Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. 2009), shareholders challenged a cash merger on the ground that the board of directors breached their fiduciary duty of loyalty by not obtaining the best sale price as required by a long line of Delaware cases beginning with *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986). *Id.* at 239. When the buyer filed a Securities and Exchange Commission form

indicating its intent to purchase a block of the stock of the target company (Lyondell Chemical Company), after recognizing that the company was “in play,” the board of directors of Lyondell had a special meeting and decided to take a “wait and see” approach to the proposed acquisition. *Id.* at 237. After subsequent negotiations between the management of the target and the acquirer, Basell AF, the board of directors met again for an hour, indicated interest, and retained Deutsche Bank as its financial adviser. *Id.* Subsequently, the board met yet again, requested a higher price, a go-shop provision, and a smaller break-up fee. *Id.* at 238. Although the acquirer reduced the break-up fee, it did not raise the price or otherwise agree to negotiate the go-shop provision or its announced schedule for the acquisition. *Id.* After a presentation by its financial advisers opining that the price was fair, the board voted in favor of the acquisition and recommended it to shareholders, the vast majority of whom approved the deal. *Id.* at 238–239. However, some shareholders challenged whether the board had considered the transaction sufficiently to obtain the best sales price in accordance with its fiduciary duties. *Id.* at 239.

It is noteworthy that only the duty of loyalty was at issue in this case, as the bylaws of the target company protected the directors from personal liability with regard to breaching the duty of care. *Id.* at 239. With regard to the enumerated *Revlon* duties for the duty of loyalty, the Supreme Court of Delaware held that these duties do not apply simply when a company is “in play.” *Id.* at 242. Rather, the *Revlon* duties apply only when a company receives an unsolicited offer or seeks a transaction on its own accord. *Id.* Consequently, the court concluded that the board did not breach its duty of loyalty because *Revlon* did not apply at the time that the Securities and Exchange Commission filing was made and only the business judgment standard applied to the “wait and see” approach taken at that time, which was met. *Id.*

In reaching this holding, the court looked at whether the board failed to act in good faith, which turned on whether the board members “intentionally disregarded their duties.” *Id.* at 243. Since the board members did not knowingly and completely fail to undertake their responsibilities, they did not breach their duty of loyalty. *Id.* at 244. The court noted, however, that due to the directors’ failure to conduct an auction or market check, and lack of “impeccable knowledge of the market,” had the duty of care been at

issue, the directors might not have fulfilled this enhanced fiduciary duty of care by their conduct. *Id.* at 253. Specifically, “the directors apparently took no action to prepare for a possible acquisition proposal. The merger was negotiated and finalized in less than one week, during which time the directors met for a total of only seven hours to consider the matter. The directors did not seriously press [the purchaser] for a better price, nor did they conduct even a limited market check.” *Id.* at 241.

From a corporate governance perspective, *Lyondell* provides guidance to board members in exercising both their duties of care and loyalty. Counsel should assist board members in developing a record to support the board’s business judgment, ensure that an orderly sales process is conducted, and ensure that decisions are made in an informed manner. Further, the duty of care may require more than a “wait and see” attitude to a possible acquisition, and the board should, upon receiving signals that an acquisition may be imminent, develop strategies to approach the same.

Impact of Alliance Data Systems v. Blackstone

In *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746 (Del. Ch. 2009), *aff’d*, 976 A.2d 170 (Del. 2009), Aladdin Solutions Inc. (controlled by Blackstone Capital Partners V LP, in turn controlled by Blackstone Group LP, a large private equity group), and its wholly owned subsidiary, Aladdin Merger Sub. Inc., agreed to acquire Alliance Data Systems, which owned World Financial Network National Bank, a credit card bank. *Id.* at 749. Under the merger agreement, a condition of closing required regulatory approval from the Office of the Comptroller of the Currency (OCC). *Id.* Specifically, the agreement contained “a promise by Aladdin to use Aladdin’s reasonable best efforts to get OCC approval; a promise by Aladdin to keep Blackstone from preventing the completion of the Merger; and a representation by Aladdin that it had the power to fulfill its commitments under the Merger Agreement.” *Id.* at 750. This approval was not obtained, however, since Blackstone, in its capacity as the ultimate parent of the buyer, would not agree to guarantee certain financial obligations of World Financial Network National Bank. *Id.* at 749. The target company brought a lawsuit against the buyer on the ground that it breached the merger agreement by not causing Blackstone to agree to the conditions of the OCC. *Id.* at 750. The Delaware Chancery Division

disagreed. In reaching this result, the court reasoned that the agreement should have specified the requirements to be imposed on Blackstone in order for the buyer to be held responsible for that entity's actions. Accordingly, care should be given to tailor both affirmative and negative covenants to the exact understanding and agreement of the parties. Clearly, the importance of *Alliance Data Systems* is effectively that significant attention must be paid to drafting, both as to whether an affirmative covenant or a negative covenant is given, but also as to which entities are responsible for performing these covenants.

We further note the existence of a subsequent decision following the precedent set in *United Rentals Inc. v. RAM Holdings Inc.*, 937 A.2d 810 (Del. Ch. 2007). In *United Rentals*, United Rentals Inc. entered into a merger agreement with RAM Holdings Inc. and RAM Acquisition Corp., which were controlled by Cerberus Capital Management, also a private equity group. *Id.* at 813–814. Like the Aladdin entities in *Alliance Data Systems*, “RAM Holdings and RAM Acquisition are shell entities with *de minimis* assets that were formed solely to effectuate transactions contemplated under the Merger Agreement.” *Id.* at 814. Cerberus was not a party to the merger agreement, but its investment fund, Cerberus Partners LP, merely executed a limited guarantee of payment obligations of the RAM entities for up to \$100 million and Cerberus itself was identified as an “equity sponsor” in an equity commitment letter, agreeing to purchase the shares of RAM Holdings stock to finance the merger consideration under certain circumstances. *Id.* at 814–815. The merger agreement (i) allowed RAM to terminate the merger in the event of a material adverse change in the business of United Rentals specifically, but not based on national credit markets; (ii) contained a specific performance provision for United Rentals against RAM, which was subject to Section 8.2(e); and (iii) Section 8.2(e), which provided that both RAM and United Rentals could terminate the agreement under certain circumstances, but limited all remedies to a \$100 million termination fee and contained a provision barring equitable relief. *Id.* at 816–817. During lengthy negotiations, the provision regarding the specific performance remedy was deleted by the purchaser's counsel in multiple drafts and the purchaser's counsel indicated that the only remedy acceptable to the purchaser in the event that Cerberus Partners failed to consummate the equity purchase would be the \$100 million termination fee. *Id.* at 817–823. However, the specific performance provision was ultimately left in the final draft, as modified by Section 8.2(e). *Id.* at 825–

826. When RAM backed out, the target company sought specific performance of the merger agreement by RAM. Id. at 827. The court agreed that recourse could not be had against Cerberus and Cerberus Partners (except under the guaranty if RAM did not pay the termination fee). Id. at 829. However, since the conflicting provisions in the merger agreement regarding specific performance and remedy limitation gave rise to an ambiguity, *parol* evidence became available to determine the true agreement of the parties. Id. at 833–834. Ultimately, specific performance was denied. Id. at 845. Again, the court noted that “[o]ne may plausibly upbraid Cerberus from walking away from this deal, for favoring their lenders over their targets, or for suboptimal contract editing, but one cannot reasonably criticize the firm for a failure to represent its understanding of the limitations on remedies provided by this Merger Agreement...” Id. Notwithstanding the court’s opinion of the conduct of Cerberus and its related entities, the seller remained without recourse.

Pending Decisions in M&A Law and Possible Protective Strategies

Given the overall flux in credit markets and the economy in general, we believe there will be increasing challenges to director fiduciary duties in the merger and sale context. Recently, in *Berg & Berg Enterprises LLC v. Boyle*, 178 Cal.App.4th 1020 (Cal. Ct. App. 6 Dist. 2009), a California court rejected Delaware precedent and limited the scope of directors’ duties to creditors of an insolvent California entity. In Delaware, when a corporation is within the “zone of insolvency,” directors owe a fiduciary duty to creditors (e.g., as articulated in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991) and *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)). Departing from this rule, the *Berg* court found that the board had a duty to avoid “actions that divert, dissipate or unduly risk corporate assets that might otherwise be used to pay creditor claims,” but does not otherwise owe a duty to creditors. Id. at 1041. Notwithstanding this holding, we believe that the actions of directors will be under increased scrutiny by both shareholders and creditors. Therefore, care must be given to assist management as well as board members in exercising their business judgment to make informed decisions. In many situations, it is important to obtain expert valuation opinions and market studies to fully understand the competitive landscape.

Given overall depressed share prices, we also believe there is a likelihood of an uptick in hostile takeover attempts. As pre-emptive steps, anti-takeover measures should be explored, again being mindful of fiduciary obligations to shareholders. Also, given the fluctuating value of the dollar, we expect to see an increase in cross-border activity including strategic investments by sovereign wealth funds and investors. In the M&A context, deal defensive strategies will become more commonplace, including go-shop provisions and break-up fees. In addition, as the regulatory environment becomes more stringent, walk rights, detailed affirmative and negative covenants, and price adjustments will be subject to heavy negotiation. However, at all times, the necessary evaluations of the transaction by the board of directors must be undertaken in order to meet the *Revlon* and other tests.

Changing Negotiation and Settlement Strategies

Based on recent cases, we believe greater emphasis needs to be placed on careful drafting of M&A agreements. For example, *Alliance Data Systems*, 963 A.2d 746, clearly demonstrates the importance of making sure that all relevant corporate affiliates are bound by any M&A agreement.

The decision in *Alliance Data Systems* emphasizes that careful attention must be paid to which parties are actively bound by each provision of a merger agreement. It is not enough for a parent company or affiliate of the buyer to agree not to interfere with the transaction, but the parent or affiliate must agree to actively undertake obligations. In this case, only the Aladdin subsidiaries were signatories to the contract, and the Blackstone entities were not signatories, although certain limited negative covenants were given on their behalf. *Id.* at 749. To the extent that the parties contemplate that an affiliate or parent will play a limited role in the transaction, the drafter must carefully consider the implications of each covenant given or not given. It is not enough to assume that since the parent company, as owner of the acquirer or the target company, has consented to the agreement it will in all circumstances cooperate fully, regardless of its own interests. If only the subsidiary is bound, as in *Alliance Data Systems*, the subsidiary will always have the possible legal claim that, notwithstanding any “reasonable efforts” provision, it cannot control the actions of its parent and/or affiliate company, and if these entities are not parties to the merger agreement, the other party to the transaction will have no remedy against them in the event

the transaction is not consummated. When the company is a shell company, there may be no ability to recover a monetary judgment at all. This is an issue for both the buyer and the seller in that an uncooperative parent company or affiliate on either side could potentially undermine the transaction.

Alliance Data Systems further emphasizes the important distinction between an agreement not to place undue obstacles in the way of a transaction (i.e., a negative covenant) and an agreement to genuinely engage in one's best efforts to cause the transaction to come to fruition (i.e., an affirmative agreement). Frequently, these items are not the most heavily negotiated, and we believe *Alliance Data Systems* illustrates both the tendency to underestimate their importance and the extent to which a canny parent company or affiliate can insulate itself from liability. See also *United Rentals Inc. v. RAM Holdings Inc.*, 937 A.2d 810, where Cerberus Capital Management LP similarly controlled lengthy (and ultimately successful) negotiations to preserve its ability to avoid liability for its subsidiary's failure to consummate the transaction and to limit the amount of liability even for its subsidiary.

Further, we also believe *Alliance Data Systems* reflects a new economic and business reality arising from the recent recession: increased regulatory oversight. While the guarantees sought from the Blackstone Group, Blackstone Capital Partners V LP, and related entities by the OCC in this case seem unusually stringent (i.e., the OCC "wanted Blackstone and its affiliates to sign a wide-ranging acknowledgement of World Financial's regulatory requirements"), it is clear that, based upon the current recession, regulatory agencies are seeking greater assurances as to financial security. In particular, as discussed in *Alliance Data Systems*, the clash of expectations between the regulatory agency and the acquirer's ultimate parent, Blackstone, ultimately resulted in the undoing of the merger: "Blackstone saw itself as an investor protected by limited liability, whereas the OCC saw Blackstone as a source of funds that would make sure that World Financial continued to meet its regulatory obligations." *Id.* at 755. This development was unacceptable to Blackstone based on its prior practices: "[i]t was one thing for the regulatory agency to extract capital and other requirements from the operating company itself, but to go further and have a particular Blackstone fund—with obligations to its investors to return their capital on

agreed terms—tie up its capital through agreements with a federal regulator was highly problematic.” Id. Such investors are no longer receiving the deference previously granted by regulatory agencies, who are seeking to extend regulation over not merely companies specifically regulated under law (such as World Financial), but parent companies not subject to the same requirements. Less deference to the protection of the corporate veil is being granted.

Therefore, the parties to an M&A transaction that are in industries that are subject to such regulations (in particular, banks and other financial service industry entities) should anticipate increased demands to obtain the requisite regulatory consents and draft their agreements accordingly. Such agreements should specify the actions the parties deem reasonable or unreasonable to be undertaken to obtain such consents, as opposed to relying on a generic “reasonable best efforts” standard. For example, in *Alliance Data Systems*, Aladdin Solutions agreed to use its “reasonable best efforts to take, or cause to be taken, all actions, and to do, or cause to be done, and to assist and cooperate with the other parties in doing, all things necessary, proper or advisable under applicable Laws to consummate and make effective...the transactions provided for” in the Agreement. Id. at 754. However, “Aladdin made no promise that it would cause BCP V or any BCP V affiliate to undertake any affirmative action to achieve OCC approval.” Id. at 749. The absence of any specific obligations on behalf of Aladdin or its parent companies made it very difficult for Alliance Data Systems to allege a breach of the agreement due to failure to undertake its “reasonable best efforts.” As the court said, “the time for ADS to have protected itself from the risk that the OCC would make demands that Blackstone would not accept was when negotiating the words of the Merger Agreement.” Id. at 751. Even without the requirement that specific actions be undertaken by its parent companies, had Alliance Data Systems negotiated a requirement that Aladdin Solutions take certain steps toward obtaining the approvals, Alliance Data Systems would have had a much stronger action for breach of contract. As the agreement at issue was written, the court showed little sympathy for Alliance Data Systems and effectively placed the blame on Alliance Data Systems for its failure to negotiate carefully.

We also reiterate that *Hexion* stands for the principle that “reasonable best efforts” require communications between the target and acquiring company

when previously unanticipated obstacles to the transaction appear. While it is true a company cannot be deemed to be providing its reasonable best efforts by taking actions that could defeat the transaction, the *Hexion* court expressly held that the failure of Hexion to alert Huntsman's management to its concerns was *in and of itself* a breach. Consequently, we believe Delaware courts have effectively articulated that failure to negotiate and consult with the other party can be a breach of an acquisition agreement, and we feel that the important role of negotiations and discussions with the other party during an acquisition has been re-emphasized. Consequently, all substantive concerns, including those involving difficulties in obtaining regulatory consents, must be discussed between the parties.

Therefore, we believe in a renewed importance both in addressing the limited liability for parents and affiliates of parties to the transaction and the requirements placed on these entities with regard to acquisitions, and in defining the "reasonable efforts" to be undertaken by both the actual parties to the agreement and their related entities.

Negotiating an Acquisition Agreement

We were recently involved in an attempted acquisition that was ultimately terminated due to the inability to obtain the required regulatory consents from a federal regulatory agency. Certain regulatory approvals were sought from the agency to allow the target company to restructure in connection with a stock purchase. The federal regulator refused to approve the restructuring. Fortunately, the stock purchase agreement contained a number of provisions that were protective of the interests of both parties with regard to obtaining regulatory consent.

First, the stock purchase agreement contained a provision stating that each of the parties would "cooperate with the other and use its reasonable best efforts in good faith to take, or cause to be taken, all actions, and to do, or cause to be done, all things necessary, proper, desirable, or advisable on its part under this Agreement or under applicable laws to consummate and make effective the Transaction as promptly as practicable." However, the "reasonable best efforts" provision was subsequently expanded upon, as the agreement also contained a specific provision defining the parties' responsibilities thereunder. In particular:

in connection with any proposed activity, acquisition or other event or transaction on the part of Purchaser or the Company that requires any consent or approval from, or filing or notice to, any Regulatory Authority (a “Regulatory Action”), each party hereto agrees to, upon the other party’s written request, take such actions or refrain from taking such actions, provide such information and otherwise reasonably cooperate with the other party in each case as the requesting party or the applicable Regulatory Authority shall reasonably request in connection with such Regulatory Action, in each case, to the extent necessary to obtain any required consent or approval or make any required filing or notice. Notwithstanding the foregoing, neither party shall be required to take such actions or refrain from taking such actions, provide such information and otherwise reasonably cooperate to the extent doing so would reasonably be likely to result in the imposition of any conditions, restrictions or requirements that would be materially and unreasonably burdensome on such party.

Therefore, the scope of the parties’ respective obligations as to providing their “reasonable best efforts” is defined.

Further, obtaining the requisite regulatory consents was deemed a condition precedent to the closing of the transaction, as to both the target company and the purchaser, thus making both parties responsible for obtaining the requisite consents. In connection with the conditions imposed by the agency to obtain the necessary regulatory approvals, the purchaser was protected from “any conditions, restrictions or requirements which would reasonably be likely (i) following the Closing Date, to, individually or in the aggregate, have a material adverse effect on Purchaser or (ii) to be materially and unreasonably burdensome on Purchaser. For purposes of this Section, any condition, restriction or requirement that would cause Purchaser immediately following the Closing to have voting control over less than all of the Shares purchased hereunder will be deemed to be unreasonably burdensome on Purchaser.” Similarly, the target company was protected from “any conditions, restrictions or requirements which would reasonably

be likely (i) following the Closing Date, to, individually or in the aggregate, have a Material Adverse Effect on the Company, (ii) be materially and unreasonably burdensome on the Company or (iii) to require the sale by the Company of any assets.”

A material adverse effect was defined elsewhere in the agreement as meaning:

any effect, circumstance, occurrence or change that is material and adverse: (i) to the business, assets, results of operations, financial condition of the Company, taken as a whole; or (ii) the ability of the Company to consummate the transaction or perform its obligations under this Agreement; *provided, however*, that Material Adverse Effect shall not be deemed to include (A) any effects, circumstances, occurrences or changes generally affecting the commercial banking industry, the economy, or the financial, real estate, securities or credit markets in the United States or elsewhere in the world, including effects on such industry, economy or markets resulting from any regulatory or political conditions or developments, or any outbreak or escalation of hostilities, declared or undeclared acts of war or terrorism, (B) changes or proposed changes in generally accepted accounting principles in the United States (GAAP), (C) changes or proposed changes in laws governing financial institutions and laws of general applicability or related policies or interpretations of any Governmental Authority, (in the case of each of clause (A), (B) and (C), other than effects, circumstances, occurrences or changes that arise after the date of this Agreement but before the Closing to the extent that such effects, circumstances, occurrences or changes have a materially disproportionate adverse affect on the Company relative to other companies in the commercial banking industry), or (D) changes in the market price or trading volume of the Company’s Common Stock (it being understood and agreed that the exception set forth in this

clause (D) does not apply to the underlying reason or cause giving rise to or contributing to any such change).

While the regulatory approvals required for this transaction were not ultimately obtained, and the parties mutually and amicably agreed to terminate the transaction, had the matter been forced to go to litigation, both parties would have had the benefit of a specific standard that determined what was acceptable to each party as a condition of obtaining regulatory approval (i.e., the purchaser would not have restrictions on voting its shares, and the company would not have been required to sell any of its assets, or have experienced a materially adverse effect, as specifically defined in the agreement). The parties were under an express obligation to cooperate and to share information to obtain any required regulatory approvals, while the actions they could not be required to take to obtain the approvals were defined as well. Further, the definition of a material adverse effect was also clearly spelled out to exclude general conditions. This agreement was heavily negotiated between the parties, but ultimately provided the protections necessary for both parties without compromising the requirement that they both exert their “commercially reasonable best efforts” to facilitate the transaction.

Looking to the Future

We believe that, going forward, in addition to the likely increased regulatory scrutiny and possible “material adverse effects” of the economic slowdown, the balance of power in negotiating provisions will shift. Generally, for much of 2010, we believe the power balance will be in favor of the purchaser (as in *Alliance Data Systems*, where the purchasing entity had the ability to isolate its parent companies from undertaking any affirmative obligations). However, there will be situations such as those in *Hexion* as well (where the seller actually had the power, because it was in a bidding war) where the seller has greater power. *Hexion* in fact illustrates the peril of a company being so eager to enter into a transaction that it may not undertake complete due diligence and/or compromises its negotiating ability as to the legal terms (as opposed to business terms) of a transaction. As discussed in *Hexion*, “because the buyer and its parent were eager to be the winning bidder in a competitive bidding situation, they agreed to pay a substantially higher price than the competition and to commit to stringent

deal terms, including ‘no financing out.’” *Hexion*, 965 A.2d 721. Similarly, in *Hexion*, because the agreement was so heavily slanted toward the seller, the definition of “material adverse effect” in the agreement was not protective of the buyer’s right to terminate the agreement, and damages potentially available to the target company were not capped for a “knowing and intentional breach” of the agreement by Hexion, with a \$325 million liquidated damages provision against Hexion for failure to obtain financing. *Id.* at 724. Also, Hexion had no right to terminate the agreement based on the potential insolvency of the combined company post-merger. *Id.* at 725. These provisions, in combination, severely restricted Hexion’s ability to deal with a situation where economic conditions changed drastically (as they did between 2007, when the agreement was signed, and 2008, when it was terminated), and adversely affected the value of the proposed transaction.

Hexion constitutes a cautionary tale as to the adverse impact of an uneven balance in power. For another example, we point to a recent unpublished decision by the Chancery Court of Delaware, *Airborne Health Inc. v. Squid Soap LP*, 2009 WL 4061826 (Del. Ch. 2009). In this case, Squid Soap, a company that produced specialized soap products, was acquired by Airborne under an asset purchase agreement that provided for a \$1 million purchase price at closing, with additional earn-out payments that required that the purchaser, Airborne, incur a minimum of \$1 million in market costs and achieve net sales of \$5 million of Squid Soap products within one year, or transfer the assets of Squid Soap back. *Id.* at *2–3. However, the covenants made with regard to marketing by Airborne were not a “mandatory commitment” to expend such funds, but merely a condition that required Airborne to return the assets if these goals were not achieved. *Id.* at *4. The asset purchase agreement, while including a representation by Squid Soap that no litigation was pending or threatened against Squid Soap, except as disclosed in the agreement, only contained a representation by Airborne that no legal proceedings were pending or threatened that “are reasonably likely to prohibit or restrain the ability of Purchaser to enter into this agreement or consummate the transactions contemplated hereby.” *Id.* at *8.

After the transaction closed, it turned out that at the time of negotiations, significant litigation was pending against Airborne and it was being investigated by the Federal Trade Commission and the attorneys general of

over thirty states in connection with false marketing. *Id.* at *5. The marketing and net sales provisions of the asset purchase agreement were not met, and Squid Soap sued Airborne. *Id.* at *6. The court held that since the pending litigation did not affect the *consummation* of the asset purchase, Airborne had not technically violated its representations and warranties. *Id.* at *9–11. Further, the court refused to expand the representation made by Airborne on the basis that it would effectively convert this provision “into an obligation to disclose litigation that could have a material adverse effect...on Airborne’s business.” *Id.* at *11. The court said that if Squid Soap sought such a provision, it “could have bargained for it. The negotiations over such a provision would have involved numerous drafting issues, including the phrasing of the basic standard (e.g. is/will/would/might/could [reasonably] [likely to] have [versus not have] a material adverse effect), whether to expand the impact to the business and its prospects, whether to use quantifiable standards, the inclusion of carve-outs, and a host of other issues.” *Id.* (brackets in original). However, the agreement “does not contemplate MAE-based litigation disclosure and [the court] will not re-write the APA to include such a provision.” *Id.* Further, the implied covenant of good faith and fair dealing did not apply to the earn-out provisions because Airborne is not expressly obligated to expend the resources to conduct marketing, and while there were express targets upon which the parties agreed, Squid Soap did not plead that Airborne failed to meet the targets arbitrarily or because of bad faith, but because of a “corporate crisis.” *Id.* at *17–18. There was no “best efforts” provision. *Id.* at *19. Thus, *Airborne Health* further illustrates the dangers of imprecise drafting and demonstrates that non-business terms can be just as important as business terms.

Because of the general market conditions, we believe that power generally will be slanted toward the purchaser in the near future. Consequently, indemnities, termination provisions, and the representations and warranties required to be incorporated into the agreement are likely to be buyer-oriented. For example, it is likely that the seller will be required to make additional representations and warranties with fewer knowledge and materiality qualifiers. The ability to terminate an agreement will likely be granted in more situations to the buyer than the seller. As to the indemnities given by sellers, the caps will be higher and claim thresholds lower. Moreover, as in *United Rentals Inc.*, the seller may seek to require

guarantees by the controlling entity of a company (such as Cerberus) of performance by the actual operating company/purchaser of its obligations under the merger agreement.

As we have previously discussed, going forward, we are looking to define more precisely the obligations of the parties to take action to consummate a transaction (beyond merely engaging in their “reasonable best efforts”). Parties must anticipate greater difficulties in obtaining regulatory approvals and draft acquisition agreements accordingly.

Further, we believe additional emphasis needs to be placed on “walk rights” based on material adverse effects and other conditions. However, based on *Hexion* and the clear hostility of the Delaware courts to companies that seek to terminate acquisitions based on materially adverse effects, to the extent that a party wishes to functionally have the ability to terminate based on a material adverse effect, the definition must be very clear. Conversely, based on the current economic conditions, it would be inadvisable for a party to allow the other party to terminate based upon a material adverse effect that is not specifically linked to the target company, as the recession could generally constitute a material adverse effect for almost any acquisition agreement. Therefore, we foresee a greater importance being attributed to negotiating such provisions.

New Strategies for Structuring Legal Documents

Due to recent developments in this area, we have been paying particular attention to revising our acquisition agreements. As we have described, we have focused on defining what “reasonable commercial efforts” mean to each party in each unique situation in order to ensure that the parties have a meeting of the minds in relevant situations as to precisely what the contract binds them to, and what conditions are unreasonable for the consummation of the transaction.

Similarly, we have reevaluated the importance of provisions that allow either party to terminate the transaction in certain specified circumstances (of which material adverse effect clauses are merely one example). For example, in the transaction discussed previously, the acquisition was ultimately terminated for the inability to obtain regulatory consents;

however, due in part to the negotiated provisions, the parties were able to amicably terminate the transaction in full confidence that both sides had fulfilled their obligations to exert their reasonable efforts to obtain same.

Overcoming Major Hurdles

The first hurdle many of our M&A clients may be facing in the coming year is the increased regulatory burden we anticipate may be imposed upon acquisitions. It is clear from recent press reports as well as cases like *Hexion* that regulators are imposing requirements to obtain acquisition approvals that have never before been seen in the financial industry—from the language of the opinion, even the judge acknowledged that the demands being made by the OCC were unusual and excessive. The essence of the benefit of limited liability created by having a multi-layer parent-subsidary structure and in having affiliates is that the ultimate parent is not responsible for the financial obligations of the ultimate subsidiary. It is no coincidence that *Hexion* (owned by Apollo Management Group), *United Rentals Inc.*, and *Alliance Data Systems* (parent company was Blackstone Group) all involved private equity groups. Like certain hedge funds, private equity groups are very involved in a variety of industries and have provided investment funds to many different companies, based on the premise that the liability of the private equity investors is limited, and that the corporate veil will not be pierced to allow investors to be liable for the companies' received funds, which are in a variety of industries. However, hedge funds and private equity groups are not heavily regulated entities. Continued regulatory efforts to “pierce the corporate veil” for regulatory requirements will not only complicate the process of obtaining regulatory approvals (as in *Alliance Data Systems*), but may also result in decreased investment by certain types of funds and private equity groups.

We will advise our clients to be prepared to experience difficulties in obtaining regulatory approvals for acquisitions, and we will draft our agreements to more carefully define the obligations of the respective parties in obtaining same. Clients can be prepared for the increased difficulties by carefully maintaining their files as to correspondence with regulatory agencies, allocating additional time prior to closing the transaction for obtaining such approvals, and ensuring that they generally remain in compliance with all regulations, so as to ensure a simpler review and more

comfort by the regulatory agency. They should anticipate the necessary information that must be provided to the agency and procedures required, as well as demands likely to be made of any parent and/or affiliated companies so that the agreement may allocate responsibilities accordingly.

We also believe the due diligence required to successfully consummate an acquisition is increasing and will continue to increase over time. First, investors will require more information (in particular, with regard to historic financial disclosures and forecasts) in these times of reduced credit. Further, the necessity of fully understanding a company's current and anticipated financial condition is illustrated by *Hexion*. According to the background information provided in the case, Huntsman began to solicit bids in May 2007. *Hexion*, 965 A.2d at 723–724. Hexion was among the bidders, and made a previous offer before signing a deal on July 12, 2007. *Id.* at 724. Based on these expedited timeframes, it appears questionable whether Hexion had the opportunity to conduct sufficient due diligence before making its final bid, and the opportunity to negotiate the agreement fully. The panic at Hexion arose after Huntsman's financials for the first quarter of 2008 were released and Hexion was forced to reevaluate its business model. *Id.* at 725. It appears that the private equity group that controlled Hexion, Apollo, may have made representations to its investors regarding returns that could not be achieved given the unfortunate first quarter results of Huntsman. *Id.* at 725, fn. 8.

Consequently, given the current economic climate, we will encourage our clients to engage in more detailed due diligence, particularly as to financial documents. First, the economic climate is currently very unstable, and large losses appear possible in many sectors of the economy going forward into 2010. Further, it is much more difficult to obtain credit at this time than it has been historically. It appears likely that both institutional lenders and private investors will require more information than in the past before lending money. As in *Hexion*, failure to negotiate a financing contingency into the agreement could potentially be disastrous in the event that the purchaser has difficulty in obtaining credit. In *Hexion*, failure to obtain credit would have resulted in the seller receiving the contractually stipulated damages of \$325 million. *Id.* at 721. In its efforts to avoid paying this significant amount of money upon discovering solvency concerns that Hexion knew would endanger its ability to obtain financing, Hexion instead

committed a breach of the contract that was deemed “knowing and intentional” by the court, resulting in no cap on the damages potentially available to Huntsman. *Id.* at 757. Neither choice was beneficial for Hexion, and it was left in a very unfortunate predicament that could potentially have been avoided with a greater opportunity to conduct due diligence prior to entering into the transaction or by negotiating the financing provision differently.

We also intend to revise our initial due diligence queries to be more specific. Clients can be prepared to facilitate due diligence by reviewing their files comprehensively and collecting relevant data prior to the initiation of any acquisition talks. All responsive information needs to be provided simultaneously for review by the other party. Due diligence should not be viewed as a formality that must be complied with in order to provide a reasonable basis to approve a transaction, but as a valuable opportunity to either explore the condition of the target company or, conversely, to explain the precise state of the target company to the potential acquirer in order to avoid misunderstandings that could potentially threaten the transaction. Expedient and full compliance with requests will facilitate the completion of the transaction and form trust between the participants. Last-minute surprises are not good for either party, and may lead to risks that are not contemplated by the original transaction document. For example, we have participated in a transaction where due diligence materials were still being provided by the sellers days before the closing after nearly one and a half years of negotiating the acquisition agreement, as the target did not organize its information production. The transaction was seriously threatened at many points due to the surprises that constantly arose and required redrafting of the agreement on multiple occasions, resulting in delay and greater expenses for all parties involved.

Finally, we believe that in light of the current economic conditions, it will be necessary to provide the parties with additional opportunities to exit the transaction if necessary. Unanticipated downturns in business or in a specific industry may result in the transaction no longer being as desirable to either party. Therefore, it will be important to negotiate provisions allowing termination in a variety of situations, such as due diligence issues. For example, additional rights of termination based upon information obtained during due diligence after entering into the agreement could have

saved Hexion from its predicament. This is primarily a drafting issue, although clients again must appreciate that the legal terms of the transaction are nearly as important as the business terms, and evaluate negotiations accordingly.

The Impact of a New Administration

We believe the change in administrations from the Bush administration to the Obama Administration has resulted in a different regulatory climate for our M&A clients. We note that there are a number of initiatives and items of pending legislature that would regulate the credit industry and financial services industry more closely. Further, as we previously indicated, we believe that generally, regulatory agencies will impose more significant requirements to obtaining the requisite consents for an acquisition. As we have previously addressed the additional regulatory burdens at length, we would like to additionally note that the issue of executive compensation has also become a particularly hot issue.

Executive compensation has become a very relevant and timely consideration. In particular, we note that in mid-December, Kenneth Feinberg, President Obama's pay czar, announced rules that restricted the amount of compensation for executives of companies that have received federal bailout funds under the Troubled Asset Relief Program and other programs. Further, in addition to setting a specific amount of pay, Mr. Feinberg also imposed the requirement that a portion of these executives' compensation be in "long-term" compensation, such as stock that is required to be held for at least three years. While these requirements are applicable to companies that have received federal stimulus funding and not repaid the same, we believe this signals a trend throughout the industry. For example, Goldman Sachs (which has already repaid its federal loan and is not technically subject to these requirements) announced in a December 10, 2009, press release that it would not pay cash bonuses for its management committee, but would award stock that must be retained for a minimum of five years ("shares at risk"), which would allow the firm to recapture shares in the event that the employee took undue risks. See Press Release, Goldman Sachs, "Goldman Sachs Announces Changes to 2009 Compensation Program" (December 10, 2009), available at www2.goldmansachs.com/our-firm/press/press-releases/current/compensation.html.

Therefore, we believe the renewed current focus on executive compensation could have an impact on M&As in 2010 and in the future. In particular, it may affect earn-outs. As deferred payments to the seller of a company, earn-outs fit in with the current trend against short-term compensation in order to ensure long-term results and may become more common, particularly in the troubled economic conditions that may make it difficult to pay a premium purchase price up front. Earn-outs also have the benefit of allowing the purchaser to evaluate an acquired company's results over time. Consequently, we believe earn-out provisions may become more common with regard to the sale of a company when individual shareholders are involved. It is also possible that we will begin to see earn-outs that are structured over a longer period of time. However, the seller may experience an inability to hit the earn-out targets that is caused not by the company's operations, but by the general market conditions as well.

For a cautionary example, we point once more to *Airborne Health Inc.*, 2009 WL 4061826. As illustrated by this case, it is essential for the party receiving an earn-out to carefully draft the relevant provisions. In *Airborne Health*, the court held that since the agreement provisions did not make the buyer's provision of marketing funds and net sales goals mandatory (merely providing that the purchased assets would have to be returned if these actions were not taken), there was no remedy for breach of contract when the buyer failed to do so. *Id.* at *11. The court further expressed an unwillingness to expand the transactions contemplated by the asset purchase out to include the subsequent earn-out, without express language in the agreement. *Id.* Therefore, any seller receiving an earn-out must make the performance of any post-closing agreements by the buyer an express obligation, and must carefully specify the requirements to be imposed upon the buyer. *Airborne Health* further illustrates both the difficulty of achieving earn-out goals in the current economic environment and the necessity for detailed due diligence (had the seller been aware of the agency investigations and litigation surrounding the products sold by Airborne, it might have taken greater care with drafting, or not undertaken the transaction at all).

The *Airborne Health* court noted that “[w]hat an earn-out (and particularly a large one) reflects is disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. In theory, the earn-out solves the

disagreement over value by requiring the buyer to pay more only if the business proves that it is worth more only if the business proves that it is worth more.” Id. at *3. Clearly, the court recognizes the value of an earn-out as a negotiating tactic. However, it warns that “since value is frequently debatable and the causes of underperformance equally so, an earn-out often converts today’s disagreement over price into tomorrow’s litigation over the outcome.” Id. Consequently, careful drafting of earn-out provisions is vital both in protecting the interests of the seller and in preventing subsequent litigation by the seller simply because the earn-out goals have not been met (regardless of the contributing factors). Effectively, one can see this as an outgrowth of the “reasonable efforts” standard we have previously discussed at length herein, by extending agreed-upon reasonable efforts by both parties beyond the closing.

The Economy’s Effect on the M&A Market

The economic downturn has certainly affected M&As. Aside from acquisitions becoming less common generally, as we have discussed, the uncertainty created by the current economic climate requires greater drafting care for all parties. Buyers will want to provide for additional termination rights and additional due diligence. Sellers will want additional certainty that the buyers can obtain financing and that they will follow through on the transaction (*United Rentals Inc.* provides an example of the importance to the seller of certainty given that the seller continually sought to have the shell subsidiary’s parent company guarantee the subsidiary’s obligations to perform the transaction contemplated by the merger agreement). As in *United Rentals Inc.*, sellers may seek to insert a requirement of specific performance. However, generally, we believe buyers will have greater power to negotiate provisions because it is a buyer’s market.

We do believe, however, that although the recession is certainly a negative occurrence, positive developments may rise out of the caution that we perceive is currently deemed necessary, and will be deemed necessary to negotiate and consummate acquisitions successfully in the near future. For example, more careful drafting, the obligation to participate in substantive discussions regarding all issues that arise during the road to closing a transaction, and increased due diligence requirements are quite possibly, in the long run, beneficial for everyone undertaking an acquisition.

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