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Business Law Update

Fall 2015

Mergers & Acquisitions

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For more details on any of the topics covered in this *Business Law Update*, please contact the authors via the links at the end of each article or David R. Valz, editor-in-chief. For information on our Corporate Transactions & Securities practice, please contact Frank D. Chaiken, practice group leader.

Crossing the Line – An Introduction to Line-Item Indemnities in M&A Transactions

By William M. Henry

A line-item indemnity is typically given by the seller in favor of the buyer, and is addition to the regular indemnities included in a standard purchase agreement (relating to breaches of representations, warranties and covenants). The line-item indemnity specifically identifies a particular issue for which the seller would indemnify the buyer in the event of future, but not yet incurred, losses. This type of indemnity can therefore constitute a strong statement by the buyer to the seller that, notwithstanding all of the existing indemnification provisions in the purchase agreement that are intended to address unknown risks and liabilities, there is an important, troublesome diligence issue for which the buyer expects the seller to assume most, if not all, of the losses.

Frequently, line-item indemnities arise for environmental, benefits or tax-related issues, often where the buyer believes the seller has not complied with applicable laws, and where, as a result, post-closing fines or penalties may be assessed. For example, a buyer may request a line-item indemnity for potential environmental fines relating to the clean-up of an underground storage tank, or for potential IRS penalties relating to the failure to file required payroll documentation.

Considerations for the Buyer

Scope/Purpose. As a practical matter, buyers prefer not to have to negotiate line-item indemnities, since the impetus for such indemnities is a problem that the buyer has identified in diligence. However, once the buyer determines to request a line-item indemnity, the buyer will need to demonstrate to the seller that (i) the underlying issue is a real possibility and (ii) the seller cannot cure the issue pre-closing. If the issue is not likely to ever occur, the seller will resist the indemnity on the

basis that the risk is too attenuated to be worthy of supplemental indemnification. Likewise, if the seller can cure the issue pre-closing, then both parties would likely prefer the seller do so rather than deal with negotiating an indemnity.

Timing. Opinions vary on what the best time is (in the transaction's life cycle) for the buyer to propose a line-item indemnity to the seller. Some prefer waiting until later on in the process, on the thought that the buyer can push through the indemnity with a desperate/eager seller or otherwise trade the indemnity for some other negotiated point. The problem with this approach is that, even though its heavy-handedness may eventually work, it can delay the closing or otherwise motivate the seller to be unnecessarily aggressive on remaining points. For these reasons, a second alternative may be more productive: the buyer may elect to propose line-item indemnities as early as it can practically identify and quantify the risk. Since line-item indemnities increase the seller's risk and liability exposure, and since most buyers would prefer to clean the issue up prior to the closing, disclosing the request for the indemnity early on is more likely to promote discourse and a constructive resolution. This approach does not mean that the buyer should gun-jump and disclose every possible issue as early as possible to the seller—lest the buyer desire a paranoid seller—but rather that the buyer should, in consultation with its counsel, be cognizant of issues and bring them to the forefront early on.

Considerations for the Seller

Mitigation. The issues underlying line-item indemnities are distinct from issues underlying purchase price reductions in that with an indemnity, there is a likely but uncertain risk of loss, while with a purchase price reduction, there is a certain, calculable loss. Line-item indemnities can therefore represent gap-bridging where the buyer only intends to make an indemnity claim against the seller in the event the underlying issue ripens following the closing (e.g., a penalty is actually imposed relating to noncompliance). By contrast, a purchase price reduction reflects the buyer's determination that the loss (such as loss of customers or other value) has caused the target to be less valuable than before the issue was identified. Accordingly, it behooves the seller to ask the buyer—and work in concert with the buyer—to circumscribe the risk as much as possible, and identify whether it is feasible to correct the issue prior to the closing, thereby negating the need for the indemnity.

Limitations. While line-item indemnities are not often subject to dollar limitations (carved out from the basket and the cap) that may apply to general indemnity claims, line-item indemnities can also be subjected to their own limits. As a straightforward example, if the parties identify the potential losses relating to a matter that is the subject of the line-item indemnity as being $1,000,000, then it is reasonable to cap the seller's exposure at that amount.

Opportunism. The seller should be cautious that some buyers use line-item indemnities as opportunistic tools to impose incremental, if delayed, purchase price reductions. Therefore, the seller should use a buyer's request for a line-item indemnity to ask the buyer if it expects to discover in diligence any other issues that may rise to the same level. If the buyer responds by indicating that there may be other issues, then the seller may be able to take the opportunity to proactively address those issues before they rise to the level of concern requiring a line-item indemnity, while if the buyer indicates that the issue underlying the proposed indemnity is all that the buyer has found thus far, then the seller can use this statement as a basis for resisting subsequent requests for additional line-item indemnities.

Final Considerations

Line-item indemnities, while occasionally difficult for the parties to work through, can be a tool for allocating known risks that arise in the course of an M&A transaction. For the buyer, they serve to provide additional comfort that an identified, substantial risk will be fairly allocated to the seller if it ripens. For the seller, the proposal of a line-item indemnity gives the seller an opportunity to limit the exposure relating to the indemnity by identifying costs of cure, and if the indemnity sticks, in any event, the indemnity may be preferable to a direct purchase price reduction or, worse still, a buyer that is no longer willing to close the transaction.

With any questions, please contact Will Henry.

Corporate Governance

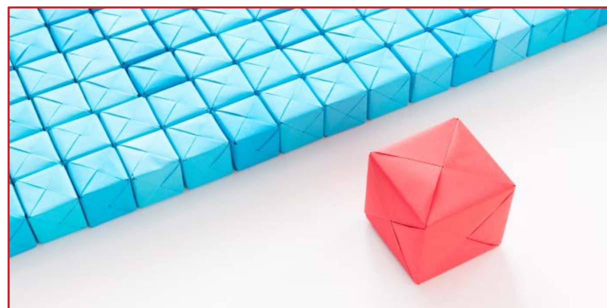
Auditor Independence – The Role of the Audit Committee
By Tammy P. Bieber

In 2002, Congress tasked the audit committee with overseeing the retention of the company's *independent* auditor and pre-approving all non-audit services provided by that independent auditor to safeguard against impairment of auditor independence. Accordingly, the SEC views the independence of the auditor as a shared responsibility between the audit committee and the auditor. In June of this year, the SEC put teeth to that view and charged the trustee of an investment fund and the fund's administrator with causing violations of the auditor independence rules.

Given the SEC's enforcement agenda against gatekeepers and its view of the independence obligations, directors and trustees are well-advised to refamiliarize themselves with the independence rules generally and their role in monitoring independence specifically. This second installment of a three-part series focusing on auditor independence outlines the role of the audit committee in maintaining and overseeing auditor independence. (Read the first article in the series on our website.)

Independence Considerations

The auditor must be independent throughout the audit engagement as well as the period covered by the financial statements to be audited. When considering the independence of a potential or returning auditor, the audit committee should take a broad view to capture any relationships or services that could be viewed as impairing independence. At bottom, the question is whether a reasonable investor would conclude that the auditor was incapable of exercising impartial judgment. The answer to that question may be unclear to many when the payment of audit fees by the client does not raise an independence issue, but there are several considerations that help shed light on when independence might be considered impaired. As a general rule, independence would be deemed impaired and the work should not be undertaken if the audit or non-audit service under consideration would:



- create a mutual or conflicting interest between the auditor and its audit client;
- place the auditor in a position of auditing its own work;
- result in the audit firm acting either as management of the audit client or as its employees; or
- place the auditor in a position of being an advocate for the audit client.

Prohibited Relationships and Services

The Sarbanes-Oxley Act of 2002 (Sarbanes Oxley) defined certain prohibited relationships and services. Audit committee members should be familiar with the enumerated prohibited arrangements but must also be cognizant that these prohibitions are not all-inclusive. For instance, even though tax services do not generally raise independence issues, the Public Company Accounting Oversight Board (PCAOB) warned that a conflict of interest between a company and its auditor may arise if the company faces legal liability or sanctions based on a tax strategy developed by its auditor. The audit committee must therefore consider the impact on independence of all non-audit services or relationships whether or not they are expressly banned using the above-listed factors as a guide.

Prohibited Relationships

There are essentially four types of relationships prohibited under Sarbanes Oxley. First, to eliminate the possibility that an audit team member is acting in his or her own interest in the hopes of gaining employment with a client, Sarbanes Oxley requires a one-year cooling off period before a company can hire certain individuals formerly employed by its auditor. On the flip side, audit firms and/or their partners cannot maintain any direct or material indirect business relationships with the company, its officers, directors or significant shareholders. Third, the audit firm cannot be

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perceived as having any interest in the client and as a result, audit committees cannot remunerate an independent auditor on a contingent fee or a commission basis. And finally, certain financial relationships between the company and the independent auditor are prohibited, including a debtor/creditor relationship, banking, broker-dealer, futures commission merchant accounts, insurance products and interests in investment companies. Thus, if the potential audit client is a bank, the audit firm could not bank with that entity.

PCAOB Rule 3526 requires that a registered public accounting firm provide to the audit committee of a prospective audit client a description of all relationships between the accounting firm and the audit client that may reasonably be thought to bear on independence, and must discuss those relationships with the audit committee.

The audit committee must get comfortable that the disclosure identifies (1) all persons in financial reporting oversight roles whether they are company management or directors, and (2) any relationships the audit firm, its affiliates and/or its partners have with any individual in a financial oversight role at the company, including through those individuals' involvement with other companies. The committee should, therefore, query the auditor to understand, at a minimum, the processes the audit firm has in place to ensure that all relevant relationships have been captured, and any relationships deemed immaterial by the audit firm and thus omitted from the disclosure.

The auditor must provide the disclosure annually and certify that it is independent.

Prohibited Services

In addition to the prohibited relationships, Sarbanes Oxley enumerated certain prohibited services. Thus, the auditor cannot provide the following non-audit services to an audit client or its affiliates:

- Bookkeeping;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker-dealer, investment adviser, or investment banking services; and
- Legal services and expert services unrelated to the audit.

Because the above-listed services are not all-inclusive and because permitted services can expand in scope so as to create independence issues, Sarbanes Oxley mandated that the audit committee pre-approve permitted services. The audit committee should be comfortable that the company has in place policies and procedures that ensure that all audit and non-audit services get to the committee for pre-approval. Those policies should provide the committee with enough detail of proposed engagements and fees to understand the nature and scope, analyze any potential independence risks, and put in place mechanisms to guard against scope creep. Moreover, services subject to general pre-approval must be specifically defined because categorical approvals will not suffice in the SEC staff's view.

Given the limited number of public company audit firms and the requirement that any new auditor have been independent during a period before their engagement, listing company standards require audit committees to pre-approve all audit, review and attest services regardless of whether the firm performing the services is the company's principal auditor. In that regard, it is a good practice to maintain at least one potential audit firm that provides no services and has no relationships with the company, its management or directors.

Audit committees must be able to spot independence issues as early as possible in order to avoid impairment. To do that, the audit committee must have a complete understanding of the services their auditor has provided and is providing, and a general understanding of the independence rules and the concerns that those rules seek to address. That fundamental understanding should be enough to flag issues that can then be raised with the company's audit firm or with counsel.

If you have questions, please contact Tammy Bieber.

General Corporate Law

A Subtle Loophole: Circumventing §271 of the Delaware General Corporation Law

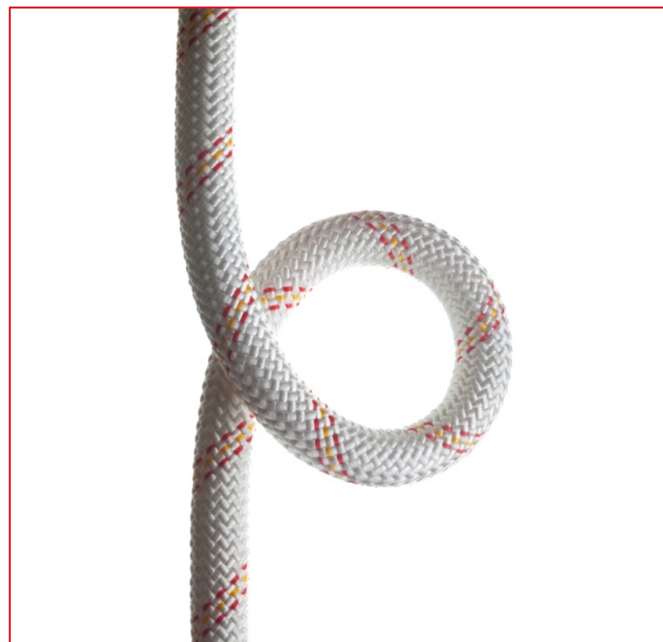
Section 271 in the Context of a Parent/Subsidiary Relationship

By Zohra Sayedy & Thomas A. Aldrich

Under Section 271 of the Delaware General Corporation Law, a Delaware corporation's board of directors is required to obtain the approval of a majority of its outstanding shareholders before the corporation can sell, lease or exchange all, or substantially all, of its property and assets.[1]

For years, legal practitioners have shown particular interest in Section 271's operation in the context of a parent/subsidiary relationship. Should a vote of a parent company's shareholders be required in transactions that involve a sale of assets by a subsidiary? On July 29, 2004, Vice Chancellor Leo Strine of the Delaware Chancery Court issued an opinion seeming to foreclose a board's ability to change the corporation fundamentally through a transaction at the subsidiary level without first consulting with its shareholders. Strine's decision in *Hollinger Inc. v. Hollinger International, Inc.*[2] sought to protect parent shareholders, with respect to subsidiary asset sales, by rejecting the argument that the vote of a parent corporation's shareholders was not required to approve a sale of assets by its wholly-owned subsidiary. Less than one year after *Hollinger*, the Delaware General Assembly amended Section 271 with the insertion of subsection (c), which specifically provides that the assets of a wholly-owned and controlled subsidiary will be considered the assets of its parent corporation for purposes of subsidiary asset sales.[3] Under *Hollinger* and the 2005 amendment to Section 271, a parent corporation is required to treat the assets of its wholly-owned subsidiary as its own. But has the 2005 amendment fully served its purpose? There is another scenario with implications for the policy rationale behind the 2005 amendment: What about partially-owned subsidiaries?

[1] 8 Del. C. § 271(a).
[2] See 858 A.2d 342, 374 (Del. Ch. 2004).
[3] 8 Del. C. § 271(c): "For purposes of this section only, the property and assets of the corporation include the property and assets of any subsidiary of the corporation. As used in this subsection, "subsidiary" means any entity wholly-owned and controlled, directly or indirectly, by the corporation and includes, without limitation, corporations, partnerships, limited partnerships, limited liability partnerships, limited liability companies, and/or statutory trusts…"



In its 2005 Bill Synopsis, the Delaware General Assembly stated that "[t]he amendment [to Section 271] is not intended to address the application of subsection (a) to a sale, lease or exchange of assets by, or to or with, a subsidiary that is not wholly-owned and controlled, directly or indirectly, by the ultimate parent."[4] Indeed, it would seem that, based on the Bill Synopsis, a corporate board could entirely avoid the shareholder approval requirement, in a sale of all or substantially all corporate assets, by structuring around 271's "wholly-owned" requirement.

Consider this hypothetical case: X, a publicly held corporation, places all of its assets into newly incorporated subsidiary Y in exchange for all of Y's shares. Under these circumstances, Y would be a wholly-owned subsidiary, controlled by publicly held corporation X. According to Section 271(c), should X choose to sell all, or substantially all, of the corporate enterprise's assets, X must obtain approval of a majority of its shareholders. However, a shareholder

[4] H.R. 150, 143rd Gen. Assemb., Reg. Sess., at Synopsis § 28 (Del. 2005).

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vote could be avoided entirely in this situation if X transferred a nominal percentage of Y's stock to a third party, for example, the prospective acquirer of Y, thereby making Y a partially-owned subsidiary of X.

Section 271's loophole has not yet been litigated, probably due to the absence of a sufficiently exigent corporate circumstance combined with a board aggressive enough to employ the structure.[5] To be sure, there would be a significant risk of shareholder litigation, as well as the possibility that the Delaware courts would integrate the steps in an effort to pull the transaction back within the requirements of Section 271, but, given the traditional deference afforded to the decisions of a fully informed, disinterested board, including but not limited to, the "compelling justification" and "entire fairness" standards, a decision adverse to the board would not be a certainty.

With any questions, please contact Zohra Sayedy or Tom Aldrich.

Thompson Hine Earns First-Tier Rankings in Chambers USA

Thompson Hine LLP has been recognized for the 13th year in a row as a leading law firm in Chambers USA: America's Leading Lawyers for Business, which ranks lawyers according to technical legal ability, professional conduct, customer service, commercial awareness, diligence and commitment, based on interviews with clients and peers.

In the 2015 edition, Thompson Hine is named a top firm in 11 practice areas, three of which – Construction, Transportation: Rail (for Shippers) and Transportation: Road (Carriage/Commercial) – are ranked nationally: Banking & Finance, Bankruptcy/Restructuring, Construction, Corporate/M&A, Employee Benefits & Executive Compensation, Intellectual Property, Litigation: General Commercial, Natural Resources & Environment, Real Estate, Transportation: Rail (for Shippers) and Transportation: Road (Carriage/Commercial).

[5] See Mark Morton & Michael K. Reilly, *Clarity or Confusion: The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, 10 DEAL POINTS (A.B.A. Comm. on Negotiated Acquisitions, Chi., Ill.) (noting that since 2005, no lawsuits have been filed in the state of Delaware to contest Section 271's loophole).

Class Action Litigation

Found Money – Benefiting From Class Action Recoveries

By Daniel Ferrel McInnis and Donald H. Messinger

There's no such thing as a free lunch, but claiming your company's share of a class action settlement or recovery comes close.

The purpose of this article is not to justify class action lawsuits – but, rather, to inform you of how to not lose the monetary benefits of a class action settlement or recovery when your company is a member of the putative plaintiff class.

Class Actions Generally

For many – perhaps most – businesses, class action lawsuits are viewed with disdain or outright hostility. No surprise here: businesses are usually the targets of class action lawsuits brought by plaintiff lawyers. Indeed, class action lawsuits have become a cottage industry that many view as merely a means of enriching lawyers. We sympathize!

On the other hand, class action lawsuits are designed to redress wrongs suffered by large groups of potential plaintiffs at the hands of a smaller group of potential defendants (or a single defendant), where it may be impractical, inefficient or costly for the injury to be addressed by multiple individual claims or lawsuits.

Key Advice

If your company receives notice that it is a potential member of a class of putative plaintiffs, DO NOT ignore or overlook that notice. Unfortunately, such notices are often sent to members of the class without any identifying individual, officer or responsible employee. In these cases, the notices are often ignored and wind up in the trash or internal "dead letter office." This result can often benefit only the plaintiff lawyers and other class members (who often will be your competitors), as they may share in unclaimed recoveries.

You should take action now to be assured that this does not happen to you. Procedures should be in place so that ALL notices pertaining to any litigation – including potential settlements – are promptly delivered to a specific company official responsible for such matters. We recommend that the notice go to counsel, but the responsible official could be someone else who is equipped to take appropriate action.

We recognize that companies typically are not interested in enmeshing themselves in protracted and complex class action litigation. This is particularly true where class defendants may be the company's business partners. As a result, company management and counsel often are only distantly aware of cases in which the company or its interests are represented in a class action.

This dynamic changes, however, when a case (or a portion thereof) settles. Often, settling defendants pay into large, multimillion-dollar settlement funds that are distributed to qualified class members who choose to participate in the claims process. This money is calculated to reflect harms inflicted on putative class members (adjusted for some negotiated settlement discount) and is "free" for the taking, subject to some effort to submit a claim.

A company's goal should be to maximize fairly its recovery for the alleged harm. To do so requires identifying opportunities to submit claims and understanding how to avoid common mistakes that diminish rightful recoveries.

Claims Administration Process

The claims administration process is predictable, but companies are frequently caught unprepared. While companies often have some limited knowledge of major litigation in their industries, they often first become aware of a potential recovery when a claims administrator sends

them a claim notice. Often, as noted above, these claim notices are not sent to anyone's particular attention, so they are disregarded. Companies should take steps to ensure that these notices are directed to a responsible company official.

When a company receives such notice, a settlement agreement typically has been fully negotiated and executed, but not yet approved by the court. Before funds can be disseminated, members of the class are given an opportunity to opt out (i.e., to file a lawsuit outside the class), and the court overseeing the litigation must approve the settlement and certify a settlement class. While this is an important part of the process, the opt-out opportunity and associated strategy are beyond the scope of this article.

A significant gap in time – sometimes more than a year – can occur between the initial notice and the deadline to submit a claim. As a result, claims can "gather dust" and be ignored or forgotten. Companies should adopt policies to ensure that this does not occur. We recommend that companies track claim filing deadlines and implement timely reminders.

Further, a significant amount of work may be necessary to submit a claim. An initial assessment should be done to determine whether the potential recovery is sufficiently large to justify the time required to prepare a claim. Moreover, that assessment should consider how difficult it may be to document a claim. Companies with a substantial claim will likely require more time and resources to prepare a detailed claim and should plan accordingly.

Another common mistake is to treat the claims process as a ministerial function. Class members submit claim forms to a claims administrator – which sounds simple enough. As the name suggests, a claims administrator is a company hired to hold in escrow the settlement funds, administer the process of providing notice to potentially affected parties, qualify claims and, ultimately, distribute the funds.

Successful claims administration depends on having access to information about the total amount of the potential recovery. While the discovery during the class action may have provided an administrator with some information – for example, who should receive notices – that information can be incomplete or incorrect. As a result, claims administrators rely heavily upon claimants' submissions to determine the amount of funds to be disbursed. Therefore, companies submitting claims need to understand what data are necessary to quantify a claim. Usually, this is explained in the claim notice or on a dedicated website.

Another important consideration for potential claimants is missing or archived data. Commonly, a settlement covers transactions that occurred many years before the claim's submission deadline. Accessing electronically stored information can be difficult (and expensive), or the information simply may no longer exist. In such cases, it may be necessary to prepare estimates in a credible and empirically based manner and defer to the claims administrator to qualify them in the recovery process.

"Missing" business entities present another challenge. While the settling defendant(s) may provide the claims administrator with data, that data may misidentify the proper parties. A company should not assume that, because some but not all of its business units received claim notices, the notices correctly identify which entities are entitled to the recovery. Your company may be entitled to recovery under prior business names, names of divisions or names of subsidiaries or affiliates.

Prompt attention to the foregoing will enhance your opportunity to maximize your recovery.

Conclusions

Finally, it is a misconception that participating in the claims process is bad for a future business relationship with the settling defendant(s) and, therefore, is not worth the business risk to submit a claim. By the time a defendant has agreed to a settlement and funded it, its role in the process is effectively over. Settling defendants are unlikely to know or care who submitted a claim.

In sum, paying attention to the claims administration process and making a well-reasoned cost-benefit assessment about participating can pay off and result in your company receiving an unexpected windfall – namely, a relatively free lunch.

With any questions, please contact Dan McInnis or Don Messinger.

Investment Management

The New (and Difficult) Environment for Emerging Managers

By Richard S. Heller

Although emerging hedge funds have, on average, the best alpha during their early years, they find it more difficult than ever to raise capital. There are numerous challenges they face today that did not exist before 2008.

Market Conditions

In the Dow, S&P and other trading platforms today, volatility in the marketplace has begun to set off alarms in the institutional and retail investor world. [This was not helped by CALPERS' withdrawal from its hedge fund positions.] Indeed, nearly every category of potential investor has begun to retreat from alternative investments; the prevalent question they seem to be asking is not if but when the six-year run-up in the present bull market will end. Family Offices have begun to hedge their portfolios by moving significant portions of their assets into cash. Hence, money that might have been available from these investors has evaporated.[6]

Infrastructure and Compliance

Due to increasing due diligence demands, emerging managers must be able to do more with less. Oftentimes, funds are run by two or three people and may have only a Chief Investment Officer and Chief Operating Officer. Indeed, the vast majority of the 8,000 funds that exist today are actually small businesses.

Because of Dodd-Frank, absent self-perfecting exemptions, funds must now register as state registered investment advisers (RIAs) and have robust conflicts and procedures manuals in place. With their typically small staffs, not only do they need to make savvy investments that set them apart from their competition, they need someone (frequently the manager) to act as their in-house Chief Compliance Officer and ensure strict adherence to their manual; this is in addition to marketing the fund.

To further complicate matters, the SEC's Office of Inspections and Exams (OCIE) has increased its staff to enable it to visit over 1,400 RIAs (which will impact funds that are SEC registered). The OCIE will review a fund's Private Placement Memorandum, Limited Partnership Agreement, Subscription Agreement and LLC Operating Agreement as well as the fund's marketing materials. To ensure consistency, all the documents must be updated to ensure that they're each saying the same thing. While this may sound easy, given the above-described numerous responsibilities a manager may have, it is not. More often than not, the OCIE has found that the marketing materials have been kept current while the other documents have not.

The SEC has recently announced that funds must establish robust cybersecurity systems. While there is no "magic bullet" solution that a fund can buy, there are numerous IT firms that offer services to combat the latest threats. In the context of this discussion, however, it is yet another added cost that an emerging manager needs to deal with.

Potential Opportunities for Emerging Managers

While the discussion thus far has focused on the numerous obstacles emerging managers face, there are ways to deal with each problem.

[6] Note this is not the case for private equity deals. Because of the very nature of their long-term investment, PE funds have become more attractive than ever before.

First, hiring good professionals is key to attracting capital. The pedigree of a fund's counsel, accountant, prime broker,[7] administrator and third party consultant is key to launching a fund. In today's environment, when investors are doing their due diligence, the first thing (among many DDQ issues) they see is those providers. In addition, having fulsome Term Sheets is critical to a potential investor's "first look." Because there are so many investment opportunities, having something that distinguishes your strategy and potential for success makes those choices critical at the outset of a fund's inception.

Next, whether to launch in the Caymans, British Virgin Islands or Bermuda (an increasingly friendly jurisdiction) is something a manager should analyze. Does a domestic standalone fund suffice or would a Master Feeder approach offer the manager more flexibility to attract investors? Indeed, many emerging managers have contacts overseas in Europe, Asia or Latin America; it is not unusual to pursue an off-shore fund in advance of starting a domestic fund.

Another factor not to be overlooked is the "friend and family" approach. Because a fund's track record over its first six months is so important, launching a fund with a *de minimus* amount of assets under management (AUM) is, in the long run, not as important as starting that six-month track record. If a manager can "knock it out of the park" for its first two quarters, it will be easier to pitch to Family Office and other major investors.

Another opportunity for emerging managers is the JOBS Act (Rule 506(c) offerings). While that Act is being revised, it is currently available to funds who wish to put their materials online for anyone to view (as long as a timely filing is made with the SEC and actual sales are made only to accredited investors).

So, despite the challenges enumerated above, if a fund manager believes he or she has a product that is worth pursuing, obstacles can be overcome. People forget that the George Soroses of the world had to start somewhere!

If you have any questions, please contact Rich Heller.

[7] It should be noted that JP Morgan has recently left the prime brokerage space, making a manager's selection of an alternate provider even more difficult.

WHAT THE MARKET SAYS ABOUT THOMPSON HINE

Thompson Hine Recognized by Corporate Counsel as Innovation Leader for Third Year

Thompson Hine LLP has again been honored in every category for game-changing innovation in *The BTI Brand Elite: Client Perceptions of the Best-Branded Law Firms.* The firm was ranked among the top five law firms nationwide in the category "Innovation: Client Service Strategists" – those making changes other firms are not to improve the client experience. In addition, Thompson Hine was named one of 25 leading firms nationwide in the category "Innovation: Movers & Shakers" – firms delivering new services that others are not. Thompson Hine is one of only 26 firms nationwide recognized in all innovation categories.

Corporate Transactions

How Similar Is Too Similar? The Ninth Circuit's Take on Successor Multiemployer Pension Plan Withdrawal Liability in the Building & Construction Industry

By Edward C. Redder & Peggy Baron

A September 2015 decision from the U.S. Court of Appeals for the Ninth Circuit, *Resilient Floor Covering Pension Trust Fund Board of Trustees v. Michael's Floor Covering, Inc.,* serves as an important reminder of the potential multiemployer pension plan withdrawal liability – **$2.3 million** in the present case – that may attach in the building and construction industry when a business takes deliberate steps to capture a substantial number of a former business' customers without formally purchasing the former business. As a result, any such business and its advisors should scrutinize proposed transactions to identify and mitigate these risks.

Background

Under Title IV of ERISA, an employer that withdraws from participation in a multiemployer pension plan is liable for its proportionate share of the plan's vested but unfunded pension liabilities. An exception to the general rule applies to an employer in the building and construction industry. In that setting, withdrawal liability only arises if the employer (a) ceases to have an obligation to contribute under the plan **and** (b) continues to perform work in the relevant geographic area for which contributions were previously required, or resumes such work within five years (and does not renew the obligation when such work resumes). This exception is premised on the rationale that the projects of a defunct employer will be absorbed by other employers that contribute to the same multiemployer pension plan and, as a result, the cessation of contributions by the defunct employer will be indirectly picked up by other industry employers.

The *Resilient Floor* Case

In *Resilient Floor*, the Ninth Circuit Court of Appeals reversed the district court's judgment in favor of defendant Michael's Floor Covering, Inc. (Michael's). In the case, Resilient Floor Covering Pension Trust Fund Board of Trustees (Trust), a multiemployer defined benefit pension plan trust fund, was seeking to assess withdrawal liability arising from Studer Floor Covering's (Studer) participation in the Trust against Studer's alleged successor, Michael's. Prior to the lawsuit, Studer withdrew from the Trust and went out of business. Michael's, an entity formed by a former salesperson of Studer, (i) performed the same types of services as Studer, (ii) utilized the same storefront, business phone number and similar signage as Studer, (iii) employed several former employees of Studer, (iv) serviced many of Studer's former customers, and (v) purchased about 30 percent of Studer's tools, equipment and inventory at a public auction.

The district court granted judgment in favor of Michael's, finding that the two businesses did not have the same owners and operators, and lacked sufficient continuity of workforce to treat Michael's as Studer's successor. Therefore, the district court held that Michael's was not subject to withdrawal liability.

The Ninth Circuit rejected the district court's application of the successor employer test, holding that withdrawal liability of one business may attach to another business if there exists "substantial continuity" from one business to the next.

In this context, substantial continuity must be determined by reviewing various factors, with special emphasis on customer retention (as measured by customer billings) due to deliberate steps taken by the subsequent business to retain the previous business' customers. As a result, the Ninth Circuit Court of Appeals reversed the district court's judgment and remanded the case for proper application of the successorship factors appropriately weighted for withdrawal liability purposes.

Takeaways

Regardless of the ultimate outcome at the district court level, an entity that takes deliberate steps to capture a former business' customers—particularly one in the building and construction industry—and its advisors should carefully analyze whether its planned business operations could arguably be viewed as a substantial continuation of the former business based on customer retention as a result of deliberate actions taken to retain such customers. Evidence of such attempts may include, among other things:

- Use of inside information (whether formal or informal) to pursue customers of the former business;
- Use of the same space, signage, contact information, workforce, etc.; and
- Significant retention of customers, measured by customer billings.

The case also serves as a general reminder of the large liabilities that may arise from multiemployer pension plans, and the need to perform significant due diligence in this area.

For more information on potential successor withdrawal liability under ERISA, contact Edward C. Redder or Peggy Baron.

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