Nixon Peabody LLP
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Developments in mergers and acquisitions law

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Our June issue of the M&A Advisor highlights several recent developments and also discusses an often-overlooked alternative to registering acquiror stock in connection with an M&A transaction.

In this issue:

- Purchase Agreement that Results in Loss of Health Benefits a Violation of ERISA
- New Chinese M&A Regulations
- Department of Homeland Security Added to CFIUS
- California Fairness Hearings

On the ERISA front, a recent Ninth Circuit case prohibited an acquiror from taking only active employees while leaving those on medical, disability or other extended leave behind. One result of this decision will be the need for additional planning for transactions in which not all employees are to be transferred to the acquiror.

Another important development is China's recent adoption of regulations governing M&A transactions. Although many commentators have criticized the regulations because they retain broad discretion for the government to veto proposed acquisitions, they represent a significant step forward toward increased clarity and uniformity, suggesting new opportunities for foreign investors in China. They also serve as additional evidence of the Chinese government's continued efforts to make China a more hospitable environment for foreign business interests.

A third development of note is President Bush's appointment of the Secretary of Homeland Security as the twelfth member of the Committee on Foreign Investment in the United States (CFIUS). Although perhaps more of a symbolic than substantive change, the appointment may signal a heightened sensitivity to foreign investment issues following the September 11th attacks.

Our final article highlights the use of fairness hearings which are authorized by statute in California and several other jurisdictions. Such hearings offer an alternative to acquirors who wish to issue shares as consideration in an M&A transaction but who want to avoid the delays and liquidity issues presented by registering the shares or issuing the shares in a private placement.

Asset Purchase Agreement That Results in Loss of Health Benefits Held to Violate ERISA Section 510

Section 510 of ERISA effectively prohibits an employer from taking any employment action against a benefit plan participant either because the participant has exercised a right under the plan, or to prevent the participant from attaining a future right under the plan. For example, if an employee tells his or her employer he or she has just been diagnosed with a serious medical condition, the employer will violate Section 510 if it fires the employee to save money on anticipated medical plan expenses.

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In the context of an asset sale, an acquiror typically purchases only those assets it wishes, is free to hire all, some or none of the seller's employees, and may provide any benefits it chooses to these employees. Negotiations between the seller and the acquiror, however, may fix some or all of the acquiror's obligations. In a recent Ninth Circuit case, *Lessard v. Applied Risk Management*, the acquiror agreed to hire all of the seller's employees who were actively at work, on recent vacation, or on personal leave and to continue the seller's entire existing benefits package with regard to these employees. The asset sale agreement specifically provided that the seller's employees who were on medical, disability, workers' compensation or other extended leave at the time of the sale would not be eligible for the automatic transfer, but would be transferred if and when they returned to active employment. One consequence of this agreement was that six people were left out of the transaction and lost their health benefits. Five of these people were on medical, disability or workers' compensation leave. One of the five – an employee out on workers' compensation leave – sued under ERISA § 510 and won.

The companies involved argued, among other things, that (i) a corporate transaction such as this asset sale is a neutral act, (ii) an acquiror is free to hire the seller's employees or not, or to provide benefits to these employees or not, and (iii) the persons left out of the transaction were not all the high users of the medical plan because some employees actively at work were also high users yet were included in the transfer. However, the court stressed that the seller could not have excluded these employees from medical benefits acting on its own, that a consequence of the "actively-at-work" requirement contained within the asset sale agreement was to achieve a result as if the seller had excluded the employees, that a seller cannot do with the assistance of another that which it cannot do by itself, and that because both the seller and the acquiror acted in concert they can both be culpable under Section 510. The court also held that the asset purchase documents on their face evidenced a specific discriminatory intent and as a result, the two employers were not entitled to introduce other evidence to the effect that they were not discriminating.

The results of this decision should cause the parties to a transaction to pay close attention to the consequences of the terms of asset sales to be sure that otherwise neutral-appearing provisions do not end up depriving plan participants of their ERISA benefits. Ironically, to protect against Section 510 liability, an acquiror would be better advised to take many fewer employees and not replicate existing benefits. Alternatively, because welfare benefits are not vested, a seller would be better advised simply to terminate all benefit plans just before the sale. This is probably not what the court had in mind, but it may be employers' best protection against a Section 510 claim.

Though Many Remain Wary, New Chinese M&A Regulations Present Opportunities for Investors

China's recently adopted M&A regulations, which went into effect in April, have so far received mixed reviews. On the one hand, the regulations create additional legal certainty and evidence a trend toward encouraging and enabling foreign investment. In this respect, they create new opportunities for investors. However, M&A transactions remain subject to arbitrary governmental vetoes, and foreign firms continue to be prohibited from acquiring majority stakes in certain key industries. Most importantly, because the regulations represent a political compromise between conflicting ministerial interests, it remains to be seen how their provisions will be interpreted and implemented. For companies considering making investments in China, the regulations will only reinforce the need to work with counsel and other advisers who are experienced in dealing with China's complex and often opaque legal and cultural landscape.

Prior to the adoption of the new regulations, M&A transactions in China were primarily governed by principles of contract law. Foreign investors and their Chinese counterparts were therefore generally free to choose to have foreign law govern the transaction. Investors were required, however, to navigate

the various ministries and local governments in order to obtain necessary approvals on a case-by-case basis.

The new regulations provide a legal framework in which most M&A activity is to take place. Although foreign investors are therefore no longer able to agree with their counterparts to have foreign law apply, the regulations add an increased degree of legal certainty and uniformity to M&A transactions. Taken together with China's efforts to join the Word Trade Organization and its pragmatic attitude toward economic reform, the regulations suggest that the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the State Administration of Industry and Commerce (SAIC) will continue to seek to increase foreign investment in China and to make the Chinese regulatory environment more hospitable to foreign interests. Foreign investors should therefore be cheered by the adoption of the regulations and the increased opportunities they suggest. The stated goal of the regulations is to promote and regulate foreign investment in China, and to boost the level of foreign capital utilization.

Notwithstanding the positive effects, both direct and indirect, that these new regulations are likely to have, however, China continues to be a difficult environment in which to conduct M&A transactions. For example, under the new regulations:

- Chinese law and existing industry policies must be applied to all M&A transactions;
- Prior prohibitions against foreign majority ownership of companies in key industries – including banking, insurance, telecommunications, media, retail, automobiles and energy – remain in effect;
- Significant transactions must be approved by MOFTEC and SAIC based on the broad standards of whether the transactions will "lead to dominance by too few companies, hinder fair competition or harm the interests of domestic consumers"; and
- Chinese firms are prohibited from selling their assets for "significantly" less than their value as determined by domestic appraisal firms.

As a result of these drawbacks, and despite good faith efforts by China to facilitate M&A activity and boost foreign investment, many commentators remain particularly wary over the elements of the regulations that give the Chinese authorities the power of veto.

Whether the new regulations succeed at increasing M&A activity involving Chinese firms will probably depend to a large degree on how MOFTEC and SAIC interpret and implement the rules. Although the regulations continue to provide the ministries with arbitrary veto power, there is much reason to hope, based on China's recent efforts to open its economy, that the regulations may represent a first step toward a robust M&A market. What is clear at the moment, however, is that foreign investment in China remains a difficult and complex endeavor that must be carried out only with a clear understanding of the risks involved and in conjunction with legal and other advisers who are familiar with its shifting legal and cultural environment.

Department of Homeland Security Added to CFIUS

In February, President Bush installed the Secretary of Homeland Security, Tom Ridge, as a member of the Committee on Foreign Investment in the United States (CFIUS). Under a 1998 Executive Order, the President delegated to CFIUS the responsibility of investigating corporate transactions in which a non-U.S. investor aims to effectively gain control of a US business and the foreign entity exercising the control might take action that threatens national security. CFIUS is chaired by the Secretary of the Treasury and consists of ten top officials including, among others, the Secretaries of State, Defense and Commerce, the Attorney General, the US Trade Representative and the Assistants to the President for National Security Affairs and Economic Policy. Mr. Ridge's appointment brings CFIUS's membership to twelve.

A CFIUS review is initiated either by the parties to a transaction submitting a voluntary notice or at the request of a CFIUS member. The President is vested with the ultimate authority to approve or reject transactions that are reviewed by CFIUS. However, very rarely is this presidential power exercised. According to a 2002 congressional study, only one of 320 transactions notified to CFIUS between 1997 and 2001 was ultimately blocked by the President. The normal procedure is that where it becomes clear CFIUS will not unanimously approve a transaction, the companies quietly withdraw their proposal.

In the recent years, CFIUS's focus has expanded beyond the traditional defense sector to include companies with telecommunications, computer aviation and internet related assets. The September 11th terrorist attacks have sharpened the administration's focus with regard to the vulnerability of US industries involved in areas of national security. In this respect, one of the most important questions a foreign investor contemplating a transaction in the United States must consider is whether to submit a voluntary notice to CFIUS. The advantage of filing a voluntary notice is that if CFIUS clearance is received, the parties can move forward with the assurance that the transaction will not be subject to further scrutiny for national security issues. In the event that a voluntary notice is not submitted, a foreign investor runs the risk of a post-closing CFIUS investigation that could result in it having to divest itself of the newly acquired assets.

The ways in which a CFIUS investigation can impact a transaction can be seen in the recent attempt by Hong Kong's Hutchinson Whampoa Ltd. to obtain a stake in Global Crossing Ltd. The proposed transaction was scrutinized by CFIUS due to questions regarding Hutchinson's ties to the Chinese government. The heightened scrutiny resulted in Hutchinson's withdrawal from the transaction with Singapore Technologies Telemedia, its acquisition partner, agreeing to pay the full purchase price.

In these times of heightened security measures, the Global Crossing transaction is a high profile example of the role CFIUS will continue to play in foreign investments in the United States. One commentator views the addition of the Department of Homeland Security to CFIUS as raising the bar for CFIUS approval. However, there are those who view the addition more as the administration sending a signal rather than making a substantive change. Whatever the reason, the effect could result in a tougher market for foreign investors looking at a US company as a potential target and for US companies looking to foreign investors as a means of survival.

California Fairness Hearings – A Solution to the Acquiror's Dilemma of How to Give Target Shareholders Liquidity

In any M&A transaction in which acquiror stock is used as currency, the acquiror must address the target shareholders' liquidity issues. While conventional wisdom leaves many acquirors with a menu of unappetizing choices, California law may offer a solution.

Conventional wisdom holds that an acquiror has three choices:

- It can issue the shares in a private placement, and leave target shareholders subject to a one-year holding period;
- It can issue the shares in a private placement and promise to register those shares following the closing on an SEC Form S-3; or
- It can register the shares prior to closing on an SEC Form S-4.

Each of these approaches has significant disadvantages. The first leaves target shareholders at the mercy of the market for a year, which will likely make them demand a richer transaction to compensate for the risk. The second appears much more palatable to target shareholders, but because the acquiror will have to suspend registration whenever it has material non-public information, the target shareholders are still not completely liquid. In addition, the cost to the acquiror of filing and maintaining the

effectiveness of an SEC Form S-3 for a year can be significant. The third choice provides the target shareholders with fully tradable shares, but generally delays closing by six to ten weeks and causes other problems for the acquisition.

The solution, where it is available, may be a process called a "California Fairness Hearing."

Section 3(a)(10) of the Securities Act of 1933 provides an exemption from registration for securities issued if a governmental authority authorized to determine the fairness of the terms and conditions of such issuance has held a hearing and approved the terms and conditions of the issuance as fair. California is one of only five states that has adopted the use of fairness hearings. An acquiror that is able to have the California Department of Corporations pass on the fairness of an acquisition transaction will be able to provide target shareholders with fully registered stock, and will have no ongoing obligation to maintain any special status for those shares.

Despite the fact that a California Fairness Hearing will likely delay closing by up to 30 days, it is still generally faster than registering the shares on an SEC Form S-4. It is also cheaper. Also, although some acquirors may worry that a procedure that is not well known carries with it some kind of stigma, that does not appear to be the case with California Fairness Hearings. They have been used for all kinds of transactions, including very large transactions such as Cisco Systems, Inc.'s acquisition of Cerent Corporation in 1999 for $6.9 billion.

Eligibility

In order for a transaction to qualify for a California Fairness Hearings, there must be an offer and sale of securities in California. Generally speaking, the Department of Corporations will look to see if the either the acquiror or the target has a nexus with the State of California, similar to the test used to determine personal jurisdiction, to determine eligibility. A nexus will usually exist if (i) the acquiror or target has a significant business relationship to California, (ii) the acquiror is physically located in California (even if not incorporated in California), or (iii) the target has a significant number of shareholders residing in California. Thus, a fairness hearing may be an option even if none of the target shareholders reside in California, so long as there is some connection with California.

Procedure

Once it is determined that the issuance of securities would be eligible for a California Fairness Hearing and the acquiror and target have decided to take advantage of the exemption provided by the California Fairness Hearing, the following must occur:

- **Application:** The acquiror must file a proposed form of notice of hearing and an application setting forth details of the transaction similar to the documents prepared in a private placement, and pay a filing fee of up to $2,500.
- **Initial Review:** The Department of Corporations will perform an initial merit review of the application for compliance with the instruction and whether the proposed transaction and issuance of securities will be "fair, just and equitable." Upon review, the Department of Corporations may impose certain modifications to the transaction. Once the modifications are made, the application will proceed on to the actual hearing.
- **Notice:** The notice of hearing must be published and served on the target's shareholders not less than ten days prior to the hearing and no more than 30 days prior to the hearing.
- **Hearing:** Counsel for the Department of Corporations will administer the hearing. The acquiror, target and any other parties to the transaction should appear at the hearing with the appropriate officers to provide testimony, as needed. Any interested person, including the target's shareholders, may testify at the hearing.
- **Permit:** If after review and the hearing the Department of Corporations determines that the transaction is fair, it will issue a permit qualifying the offer and sale of acquiror's securities.

Once the permit is issued, the proxy and/or consent solicitation materials may be distributed to the target's shareholders and a vote may be held on the transaction. Generally, the Department of Corporations will not issue a permit if the target shareholders have already consented to the transaction prior to the hearing.

Both the acquiror and target need to be aware that with regard to those target shareholders who receive acquiror stock and who are or become affiliates of the acquiror, such shareholders would be subject to transfer restrictions even if the stock is registered or issued after a California Fairness Hearing. The affiliated shareholders would need to utilize SEC Rule 145 for any resale of the shares.

In summary, California Fairness Hearings provide acquirors with a solution to the liquidity problems that can occur when stock is used as currency in an acquisition transaction.

If you have any questions or require further information regarding these or any other matters, please call your regular Nixon Peabody contact or feel free to contact one of the attorneys listed below:

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