BUSINESS LAW OBSERVER

NEWS ON CURRENT ISSUES

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Dear Friends and Clients:

This issue of the Observer contains timely and informative articles on the following topics, and I hope you find them of interest. They demonstrate the depth and breadth of our Business Practice, and we welcome your inquiries on these and other matters you may want to discuss with us.

- Directors of a corporation may owe a fiduciary duty to its creditors as well as its shareholders, under insolvency circumstances.
- Planning for Canadian taxation for U.S. resident sellers becomes increasingly important as trade with our northern neighbor also increases.
- Changes in the Delaware corporate laws now give greater flexibility and voting rights to shareholders and directors of businesses incorporated under that state's laws.
- How to ensure that intellectual property licenses will survive a merger.
- The recent stock option backdating scandals should cause companies to examine their option granting practices.

If you have suggestions for future topics, please let us hear from you.

Sincerely,

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WHEN FIDUCIARY DUTIES EXTEND TO CREDITORS

It is well recognized that each member of a board of directors owes a fiduciary duty to the corporation on whose board he or she sits and the stockholders of that corporation. Directors of a solvent company generally owe no fiduciary obligation beyond that; that is, they do not owe any fiduciary duty to the company's creditors. The presumption is that creditors can protect themselves through the contractual agreements that govern their relationships with the company, as well as the law of fraudulent conveyance and federal bankruptcy law. Directors of a solvent company should be primarily focused on generating cash flow in excess of that amount required to pay the creditors in order to provide a return to the company's stockholders who provided the equity capital and agreed to bear the residual risk associated with the operation of the enterprise. Stockholders may sue directors derivatively for breach of that fiduciary duty.

However, when a company has become insolvent, things change. The company's directors then owe fiduciary duties to the company's creditors. The directors continue to have the responsibility to attempt to maximize the value of the entity. But the insolvency necessarily affects the constituency upon whose behalf the directors are pursuing that end. Insolvency places the creditors in the position normally occupied by the stockholders, namely that of residual risk bearers. It may be more appropriate in those circumstances for the directors to undertake a course of action that preserves the value of the enterprise in a situation where the continuation of the enterprise as, a growing concern, would be value destroying. Courts have granted creditors the right to bring derivative claims for breach of fiduciary duty against directors of insolvent companies; in essence recognizing this fiduciary duty.

There is a growing awareness of an uncertain situation where a company is still solvent but is operating in the vicinity of insolvency. In this circumstance, referred to as the "zone of insolvency," directors have the discretion, and possibly even the responsibility, to temper the risk that they take on behalf of the equity holders in order to take into account the interests of creditors. That is, directors would be exercising their fiduciary duties if they, in good faith, pursued a less risky business strategy because they feared that a more risky strategy might render the company unable to meet its legal obligations to creditors. In the proper exercise of their fiduciary duties, directors of a company that is solvent but is operating in the vicinity of insolvency should consider that the appropriate course to follow for the corporation may diverge from the choice that the stockholders or the creditors or any other single group interested in the company would make. The stockholders would prefer highly risky strategies that might result in value to the stockholders. On the other hand, creditors would not be in favor of such strategies, instead opting to pursue strategies that would result in repayment of their debt in full. The directors should consider the company as a legal and economic entity and to preserve and, if prudently possible, to maximize the company's value to best satisfy legitimate claims of all constituents and not simply to pursue the course of action that stockholders might favor as the best for them.

It is often difficult to determine when a company is in the zone of insolvency. There are two ways to calculate insolvency: (i) the "balance sheet" test which examines whether a company's liabilities exceed its assets; and (ii) the "equity" or "cash flow" test which examines whether a company can pay its debts as they become due. A company may be insolvent under one definition but not under the other, and there is no standard as to which test courts will apply. As a result, it is difficult for directors to determine whether a court would find the enterprise to be in the zone of insolvency.

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Because a company's financial difficulties may significantly alter the duties and liabilities of a director, each director should carefully monitor the solvency of the company. When a company is insolvent or in the zone of insolvency, directors should recognize that efforts to maximize the value of the company for creditors might take precedence over maximizing the value of the stockholders' interests in the company. Accordingly, directors in those circumstances should pay particular attention to the reasons for taking various courses of action and should seek legal advice to minimize the risk of personal liability.

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SELLING A BUSINESS IN CANADA: COMPLYING WITH CERTAIN CANADIAN TAX LAWS

In a recent transaction, US shareholders sold 100% of the outstanding stock in a privately held Canadian company. Canada's Income Tax Act (the "Tax Act") requires a person selling shares of a Canadian company (the "seller") to file a notice with the Canada Revenue Agency (the "CRA") to report the disposition of taxable Canadian property within ten days of a completed disposition. The notice, which is formally known as a 'Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property' (a "Request"), serves both as formal notice to the CRA of the disposition of the stock and as an application to the CRA for the issuance of a Certificate of Compliance evidencing full payment of any tax liability owed by the seller as a result of such disposition. In the event that the seller does not file a Request or fails to file a Request properly, and, as a result, the CRA does not issue a Certificate of Compliance, the purchaser of the stock may become liable to pay to the CRA a specified percentage of the purchase price, plus interest and penalties (the "CRA tax liability"). Purchasers facing this possible tax liability have required protective provisions in the purchase agreement so as to cover any expenses they may incur as a result of a seller's failure to comply with the Tax Act.

In order to protect against the possibility of becoming liable for the CRA tax liability, the purchaser in this recent transaction required a covenant that the sellers agree to pay the purchaser the amount of the CRA tax liability in the event that the sellers did not secure, within a specified period after the sale, a Certificate of Compliance from the CRA evidencing no tax liability or a comfort letter from CRA that the purchaser would not be required to remit any tax payments. Thus, at the expiration of the applicable period, if the Certificate of Compliance (or an appropriate comfort letter) was not issued by the CRA, the purchaser could require the sellers to reduce the purchase price by the amount of the CRA tax liability. The most notable concern for sellers is that there is no set timeframe within which the CRA must review a seller's Request and issue a Certificate of Compliance. In some cases, the CRA has taken over six months to respond to a Request. As a result, a seller of Canadian stock should allow for a sufficient amount of time for delivery of a Certificate of Compliance.

Under Canadian tax law, the capital gains tax liability upon the disposition of stock is 25% of the purchase price. Generally, the CRA will issue a Certificate of Compliance after taxes are paid (or found not to be due) or after security acceptable to the Minister is submitted to the CRA to insure payment of any tax liability. Importantly, however, nonresident sellers typically qualify for exemption from Canadian capital gains tax pursuant to tax treaties that Canada has entered into with other countries,

including the United States. Therefore, nonresident sellers often do not owe any taxes on account of the sale and are not required to post security.

Specifically, United States resident sellers can avoid the imposition of taxes and the posting of security by application of the Canada-US Income Tax Treaty which exempts United States residents from Canadian capital gains tax to the full extent of any gain. In order to benefit from this exemption, a US resident seller must submit a statement with such seller's Request detailing the application of the exemption. The seller must also include copies of such seller's most recent income tax returns, as filed with the US Internal Revenue Service (or other resident country, as applicable), and other proof of residency, as required by the CRA. In the recent transaction we handled, our firm assisted the sellers in submitting a Request based on a treaty exemption and the sellers were not required to post security.

In addition to the above-referenced materials, the CRA requires the seller to submit the following documents in support of a Request:

- evidence of the number of shares owned, such as a share certificate;
- the shareholder register showing the number of shares owned;
- the original purchase agreement documenting the adjusted cost basis;
- corporate resolutions concerning the sale;
- the most recent financial statements of the corporation whose shares are sold;
- the most recent financial statements of any subsidiary companies;
- the offer to purchase the shares; and
- the sales agreement relating to the actual disposition.

The failure to timely and properly file a Request may result in the CRA's assessment of a penalty against the seller in the amount of $25 per day, with a minimum penalty of $100 and a maximum penalty of $2,500. A seller of stock in a Canadian company should be sure to provide sufficient time and proper documentation to undertake the CRA process.

Despite the issuance of a Certificate of Compliance by CRA evidencing application of the Treaty Exemption to fully exempt the seller from any capital gains tax resulting from the disposition, the seller must also file a Canadian income tax return to report the disposition of the stock and reassert the application of the Treaty Exemption.

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DELAWARE LEGISLATURE AMENDS CORPORATE LAW TO ALLOW DIFFERING VOTING RIGHTS AMONG DIRECTORS

On August 1, 2005, a series of amendments to the Delaware General Corporation Law went into effect. One seemingly minor amendment may provide major benefits to corporations in terms of increased flexibility regarding voting rights among directors.

Prior to the amendment, Section 141(d) of the Delaware General Corporation Law gave a corporation the power to provide in its certificate of incorporation different voting powers for directors elected by different classes or series of stock, but was silent as to whether the same flexibility was available for directors elected by holders of the *same* class or series of stock. For corporations that had only one class of stock, such as is required for corporations that make an S Corporation election for federal income tax

purposes, the implication of the old statute was that all of its directors must have equal voting rights.

The amendment to Section 141(d) addressed this uncertainty and specifically provides that "the certificate of incorporation may confer upon one or more directors, *whether or not elected separately by the holders of any class or series of stock*, voting powers greater than or less than those of other directors."

Thus, for corporations that have one class of stock (or one class of voting stock), a provision can be added to its certificate of incorporation that an individual director or a director nominated by a shareholder or specific group of shareholders shall have greater voting powers than other directors; either generally or with respect to specific matters, such as: (i) a merger, consolidation or sale of all or substantially all of the assets of the corporation; (ii) terminating the employment of certain individuals; or (iii) incurring any indebtedness for borrowed money. Such a provision could be useful in a variety of circumstances.

For example, a business owner wants to give a minority stock interest to an employee, or several employees. The business owner can now allow these employees to serve on the board yet still retain voting control of the board.

A corporation with only one class of stock can sell stock to one or more investors. These investors can have board representation, and even without a majority control, have approval (or veto) rights with respect to certain fundamental transactions.

Unequal partners, *i.e.*, one with 60% of the stock and one with 40% of the stock, now can retain that relative voting power at the board level without having to find a third person to serve on the board or limit the board to just one person.

While this new voting rights provision can certainly be included when forming Delaware corporations, it can also be added to an already existing corporation by filing an amendment to the certificate of incorporation. Thus, as circumstances change, the corporation's certificate of incorporation can be changed with it.

The hallmark of Delaware corporate law has always been its general flexibility for corporations, and the amendment to Section 141(d) continues this trend.

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LICENSE TO MERGE: SPECIAL PRECAUTIONS MAY BE REQUIRED TO PRESERVE IP LICENSING RIGHTS

Despite a long history of case law relating to mergers, one area remains unclear: the effect of mergers on intellectual property ("IP") licensing agreements. Recent case law contributes to this uncertainty and suggests that certain precautions may be necessary to preserve valuable IP licensing rights. Depending upon the terms of the IP license at issue, businesses may want to consider obtaining consent agreements to ensure that IP licenses will survive a merger. Likewise, businesses also may want to anticipate this issue when initially negotiating these types of license agreements.

Under state merger law, in a merger the surviving or resulting company generally succeeds by operation of law to all of the assets and liabilities of the merging companies. So, in a merger, a company does not have to assign its rights to contracts and other assets to the new or surviving company, they simply transfer automatically.

The ability to have assets such as contract rights transfer automatically by operation of law is often

desirable, particularly where the contracts, by their terms, require the consent of the other party to a transfer or assignment of such contract.

Accordingly, in an acquisition situation, a transaction might be structured as a merger in order to *avoid* having to get third party consent to the transfer of contracts. However, it may be that this practice of having contracts transfer as a matter of law, even if by their terms they are not transferable without consent, may no longer be reliable in the context of IP licenses.

While mergers, and their impact on assets of the parties to the merger are governed by state law, IP licenses are also governed by a body of statutory and judicial federal law. Contemporary case law suggests that IP laws may be beginning to impact traditional state merger laws resulting in the treatment of IP rights that is different than that of other assets. However, that trend is neither uniform nor consistent. A federal court decision from 2004, one of the most recent cases to contemplate the effect of a merger on a software license, decided that "whether a merger effectuates an automatic assignment or transfer of license rights is a matter of state law." On the other hand, other recent federal court decisions have held that the licensing agreement itself, rather than the applicable state merger statute, determines whether the license can be transferred to the surviving company without the consent of the licensor. This, in effect, means that unless the license agreement clearly permits assignment without the consent of the licensor, a licensor might successfully challenge the right of a surviving company in a merger to operate as the licensee under such license despite the fact that under state merger law, all of the licensee's rights under such license transferred to the surviving company as a matter of law. The rationale for treating IP licenses differently in this way from other assets, including other contractual rights such as leases, is that the licensor retains a vested interest in the identity of the licensee of the IP. The thought being, for example, that a licensor should not be forced, by operation of state law, to have its IP licensed to a competitor unless the licensor consents or clearly agreed to a licensee's right to make such an assignment in the license agreement itself.

In the due diligence investigation prior to the merger, an acquiring company may want to consider whether or not to acquire consent from licensors for the transfer of IP licensing rights. Of course, after conducting the evaluation, an acquiring company may choose to assume the risk and proceed without obtaining consent but one should no longer simply assume that the transfer of IP licensee rights will be effective without challenge simply because the transfer occurred by operation of state law in a merger.

Similarly, prior to entering into IP license agreements, parties may want to examine the plain language of the licensing agreement to ensure that the intent of the parties is clear. If the intent of the parties is to permit IP licenses to be transferable in mergers, this intent should be clearly expressed.

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Stock Option Backdating

Beginning with a series of articles in The Wall Street Journal, a variety of issues generally referred to as option backdating have been receiving increasing publicity. The Securities and Exchange Commission and the Department of Justice have become involved, and as of mid-September, more than 100 public companies have announced that they were either being investigated or had instituted their own internal investigations into their option-grant practices.

Two companies, Brocade Communications Systems, Inc, and Comverse Technology, Inc., have had joint criminal and civil charges brought against former executives by federal prosecutors and the SEC. Moreover,

The Internal Revenue Code imposes a tax on certain telephone services. In general, this "telephone excise tax" is imposed on services for which the toll charge varies with the distance and the elapsed transmission time of the call. In recent years, most long-distance telephone service providers have switched to billing arrangements which are solely a function of the duration (and not the distance) of a call. Despite this change in telephone toll charges, IRS continued to instruct long-distance service providers to collect the tax when billing their customers. Now, however, after five straight defeats in the Courts of Appeal, IRS has conceded that it cannot properly collect the tax from duration only-based bills.

To ease the burden of determining how much tax was wrongfully collected and filing refund claims, IRS has announced that it will allow individual long-distance customers to obtain a "safe-harbor" refund of the tax when filing their 2006 individual income tax returns. The IRS safe-harbor refund amounts are very modest and vary based on the number of exemptions claimed on the 2006 return. Thus, the safe-harbor refund for individuals claiming one exemption is $30; the safe-harbor refund for taxpayers claiming two or three exemptions are $40 and $50, respectively, and the safe-harbor refund for taxpayers claiming four or more exemptions is $60.

Business entities are not permitted to use the safe-harbor. Instead (absent further IRS advice), they must compute the telephone excise tax which they incorrectly paid from March 1, 2003 through July 31, 2006 and file a refund claim. Individual taxpayers willing to plow through their phone bills for the same period may also elect to file a refund claim in lieu of accepting the safe-harbor amount.

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investors have reportedly filed in excess of 70 securities class action and shareholder derivative lawsuits against more than 25 companies.

What is Option Backdating? The term option backdating covers a variety of practices that generally relate either to the backdating of option grants or the timing of option grants in conjunction with corporate announcements. Actual backdating involves recording the date of an option earlier than its actual grant date – back to a time when the company's stock price was lower. The backdating may be intentional – through altering or forging of corporate records – or as a result of poor procedures or recordkeeping.

Unintentional backdating may result from recording as the grant date of an option the date the option was promised to an employee or a new hire, rather than the date the grant was formally approved, typically by the compensation or other board committee authorized to administer the company's option plan. Moreover, if the committee acts by a written consent rather than at a meeting, under most state laws, the grant is not effective until the last person signs the consent.

Backdating may be especially relevant for new hires. Options typically can only be granted to employees, not prospective employees. Accordingly, if a new hire is promised an option grant priced at the date when the offer of employment is made, but employment does not start for some period thereafter, the earliest the grant could be actually made would be the day the employee starts working. If the option is granted upon commencement of employment at the price promised to the employee, depending on the change in the stock price, the option may be below fair market value on the actual date of grant. This practice, if permitted by the plan, would not be necessarily improper, as long as it is properly recorded as a below market grant.

The second practice being scrutinized is the timing

of the grant of an option. Specifically, a company may intentionally grant an option prior to its release of good news, with the expectation that the news will cause the stock price to increase. Similarly, companies may delay the grant of options until after the release of bad news, again with the expectation that the stock price will decline so the employee will receive the grant at a lower price. While such a practice may not be illegal, most institutional shareholders strongly disfavor option timing.

Instances of Backdating Likely to Diminish. Most backdating in public companies will likely involve periods prior to the enactment of the Sarbanes-Oxley Act in 2002 ("SOX"). Prior to SOX, most option grants to executive officers of public companies were reportable to the SEC on a delayed basis. Beginning with SOX, option grants to executive officers must be reported within two business days. Moreover, recently enacted rules by the SEC, which become effective December 15, require extensive new disclosure by public companies of their option grant practices, further reducing the likelihood of the continuation of actual backdating.

Issues Involved in Backdating.

Corporate Law. Some option plans only permit granting options at "fair market value." Accordingly, if as a result of backdating, an option was granted at below fair market value, the option may not have been properly issued under the plan. There are multiple potential consequences for having an option not properly issued under a plan. One result would be that the option is deemed to be an ad hoc grant outside of a shareholder-approved plan, which would create problems for NYSE, AMEX and Nasdaq-listed companies subject to such shareholder approval of option grants. Alternatively, such options may be deemed to be invalid. One company, Mercury Interactive, has reportedly moved to void 2.3 million options granted to its former chief executive officer.

Accounting. Pre- 2005 accounting rules required a company to recognize a charge to earnings upon the grant of an option issued at below fair market value. Under the new accounting regime, all option grants have an associated expense, but options issued at below market value will have a greater expense. Accordingly, a company that backdated options, and, therefore, issued options at below fair market value, may have to restate its previously-issued financial statements to reflect the correct expense associated with such grants. To date, more than 40 companies have indicated either that they will or that upon completion of internal investigations they may have to restate financial statements as a result of their option-granting practices.

Tax. Tax law permits a company to grant tax-advantaged options known as incentive stock options ("ISOs"). A prerequisite for issuing ISOs is that the option be granted at not less than the fair market value on the date of grant. Accordingly, a company that has backdated an option intended to qualify as an ISO may have the option not eligible to be an ISO, which will have both tax and accounting implications for the company and the option recipient.

Similarly, the IRS has recently adopted complex new rules on deferred compensation that, among other things, make certain kinds of deferred compensation subject to very substantial excise taxes. While the regulations are still being promulgated, as a general rule, options granted at fair market value are outside of these rules. Accordingly, an option that was not issued at fair market value because of a backdating issue may inadvertently become subject to the deferred compensation rules.

Legal Exposure. Companies involved in stock option backdating may become subject to either securities fraud class action or derivative lawsuits brought by persons who purchased securities in the public market at a time

when the price of the stock was allegedly inflated because improper accounting for stock options artificially raised the company's earnings. Shareholders have already filed lawsuits against more than 25 companies.

In addition, the Department of Justice has brought criminal charges in connection with two companies and the U.S. Attorney in California announced that he has formed a special task force to investigate option backdating criminal issues.

Similarly, the SEC has brought two enforcement actions and additional actions are likely. Finally, a number of state Attorneys General and the IRS may get involved in bringing actions involving option backdating.

Backdating also Relevant to Private Companies. While public companies have been the focus of option backdating, some of the problems, such as the accounting and tax issues, also apply to private companies. For example, if a private company has not properly accounted for the expense of an option grant, the company's financial statements would be incorrect. This could cause the company to violate representations and warranties it has made to private investors or lenders or cause it to be in default under the financial covenants in its loan agreements.

Best Practices. One issue, particularly for public companies, is whether to be proactive and initiate an investigation of the company's option-granting practices. This decision is complex and should be undertaken with the assistance of counsel. In some circumstances, being proactive and self reporting a problem could gain some credit with regulatory agencies.

Going forward, all companies, public and private, must ensure that everyone involved in option grants – the board of directors, the board committee administering the option plan, executives who are making promises to employees and the H.R. employees involved in option administration – all understand their respective roles and authority and the procedures for granting an option under the plan.

Companies must develop a procedure for having the option-granting body be able to act on a relatively real-time basis to deal with option grants out of the ordinary course. For most option grants, to avoid both the issue of having an option promised to an employee before it is formally approved and also to avoid the option grant timing issues, it would be desirable to grant options once a year at a fixed time. For public companies, the set time should ideally correspond to a time when the company's earnings have recently been announced so that there will not be an issue of granting options when the company is in possession of material non-public information. Moreover, for companies with insider trading policies that either have window or blackout periods, the timing of option grants would best be made during times when the "window" is open or there is not a blackout period.

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