MY BANKER'S CONFLICTED AND I COULDN'T BE HAPPIER: THE CURIOUS DURABILITY OF STAPLE FINANCING

BY CHRISTOPHER FOULDS*

ABSTRACT

Staple financing refers to a prearranged financing package offered by a target corporation's financial advisor to potential bidders. Staple financing was commonplace during the deal boom leading up to the recent credit crisis. During this period, it received a considerable amount of negative coverage by the popular media and some skepticism by the Delaware Court of Chancery. The perceived problem is that the investment bank advising the target corporation stands on both sides of the deal in a potentially conflicted position. The fear is that the bank could steer an auction towards those bidders using the staple financing, even if those bidders would not offer the best price, so that the bank can receive the financing fees, as well as the advisory fee.

There also have been several articles, written mainly by partners at large New York law firms, defending the practice. On both sides of the debate, these articles invariably measure the benefits gained by using staple financing against the adverse impact of the bank's conflicted position. These articles are, however, written from the perspective of a period when credit markets were robust and financing was available

This article is different in that it looks at staple financing in poor credit markets. In poor credit markets, banks and bidders may have a strong incentive to escape their obligations to close on deals. It turns out that staple financing has positive results for a target corporation's shareholders in poor credit markets because it is more likely that a staple-financed deal will close. The reason is curious. It turns out the bank's conflicted position, which was the major problem in good credit markets, makes it less likely that the lender will break its commitment to lend in poor credit markets. A bank offering staple financing will be less likely to back out of its commitment because if it backs out, it will also lose the advisory fee. Thus, the advisory fee acts as a buffer to deal break-ups.

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*Judicial clerk for the Honorable Vice Chancellor Donald F. Parsons, Jr., in the Delaware Court of Chancery. The views expressed in this article do not reflect the views of the Court. The author is grateful to Edward Rock, Rob Saunders, Lisa Lamb, Ronald N. Brown, III, Joseph Carapiet, Randy Debastiani, and Scotty Litvinoff for their thoughtful comments.

I. INTRODUCTION

The world of mergers and acquisitions (M&A) is riddled with conflicts. As Robert Kindler of Morgan Stanley reportedly said at the Tulane Corporate Law Institute, "We are all totally conflicted—get used to it."[1] "Staple financing" highlights some of the most serious conflicts. Staple financing refers to a prearranged financing package offered to potential bidders by a target corporation's financial advisor. If staple financing is used, the target's financial advisor stands on both sides of the deal. The investment bank's M&A department acts as the "sell-advisor" to the target, while the same bank's financing department will act as the bidder's lender (the "stapled-lender"), underwriting bonds or syndicating leveraged loans[2] to finance the purchase. The practice is called staple financing because the financing is thought of as being stapled to the back of the bid documents.[3] A simplified diagram of a deal using staple financing looks like this:

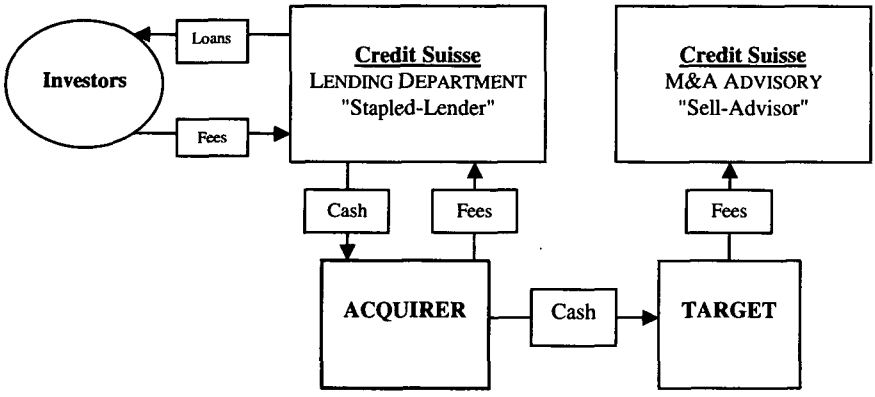

Figure 1. Staple Financing Diagram[4]

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[1]Andrew Ross Sorkin, *When a Bank Works Both Sides*, N.Y. TIMES, Apr. 8, 2007, at 3.12, *available at* http://www.nytimes.com/2007/04/08/business/yourmoney/08deal.html.

[2]Leveraged loans, which are loans made to finance leveraged buyouts (LBOs), became popular in LBOs in part because "their investors get paid off in bankruptcy before junk-bond investors." Liz Rappaport & Peter Lattman, *Anyone for Some Used Corporate Debt, Cheap?; Why Leveraged Loans that Financed Buyouts Are Causing Bottleneck*, WALL ST. J., Feb. 6, 2008, at C1.

[3]*See* Juliette Garside, *Emap: Why Don't We Lend You the Cash to Buy Us?*, SUNDAY TELEGRAPH (London), Sept. 9, 2007, at 2.

[4]Credit Suisse is used merely as a placeholder, but it has participated as the "sell-adviser" and "stapled-lender" in a variant of staple financing. *See In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1006 (Del. Ch. 2005).

Staple financing has been used around the world[5] and has numerous benefits.[6] On the other hand, the practice has raised eyebrows because of the conflicted position the bank occupies by straddling both sides of the deal.[7] If staple financing is used, the financial advisor will collect the advisory fee, as well as any financing fees.[8] The double fee creates a conflict between the sell-advisor and the target's shareholders. The concern is that the target-advisor's financial advisor may steer the sale to those bidders that will use staple financing, and away from a potentially higher bidder not using staple financing. While the conflict between the stapled-lender and the target's shareholders has been the subject of some inspection, the curious conflict occurs within the bank acting as the sell-advisor and the stapled-lender—its curiosity is the subject here.

While some have attempted to provide an analysis of staple financing, they have largely looked at the good times and balanced staple-financing's benefits against the potential conflict between the sell-advisor and the target's shareholders. By "good times," I merely mean times when deals are getting done and the loans are flowing through the pipeline to investors. This article takes a different approach by examining staple financing in bad times, such as a credit crisis. Curiously, the internal conflict at the bank acting as both sell-advisor and stapled-lender actually benefits the target's shareholders in bad times. The difference is that, in good times, the financial advisor wants to lend. In bad times, however, the financial advisor has a strong incentive to break its commitment to lend. Indeed, the *Wall Street Journal* recently reported that $150 billion worth of leveraged loans used to

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[5]Garside, *supra* note 3, at 2 (discussing the use of staple financing in the U.K. by Cadbury Schweppes and Emap in their attemps to sell off various subsidiaries); *see also* Alena Mae S. Flores, *World Bank Arm to Extend Aid to Winning EDC Bidder*, MANILA STANDARD, Oct. 27, 2007, *available at* http://www.manilastandardtoday.com/?page=business2_oct27_2007 (describing its use in the sale of the Philippine government's stake in PNOC-Energy Development Corp. by ING and the World Bank); Phineas Lambert, *Candover Sells Norwegian Cable Group*, DAILY DEAL, Nov. 20, 2007, *available at* http://www.thedeal.com/servlet/Satellite?pagename=TheDeal/StArticle&bn= NULL&c=TDDArticle&cid=1193281697899 (noting that Merill Lynch offered staple financing in the sale of a Norwegain cable group).

[6]*See infra* Part IV.

[7]*See, e.g.*, Ortsman v. Green, No. 2670-N, 2007 WL 702475, at *1-2 (Del. Ch. Feb. 28, 2007) (Lamb, V.C.) (allowing discovery into the conflicted role of the company's financial advisor); *In re Toys "R" Us, Inc.*, 877 A.2d at 1006 (Strine, V.C.) (expressing concern over the "appearance of impropriety" created by staple financing).

[8]I use the word "fees" here broadly, referring to any pecuniary benefit that flows from providing the financing, regardless of whether that benefit arrives in the form of a spread, fees charged directly to the bidder or the target, or from any other source.

fund leveraged buyouts (LBOs) were stuck in the pipeline and on banks' balance sheets.[9]

Whereas the sell-advisor/stapled-lender conflict is problematic in good times, this article attempts to show that staple financing's benefits in bad times, such as a credit crisis, largely, if not entirely, arise due to the sell-advisor/stapled-lender's conflicted position. The main benefit in bad times turns out to be increased deal "durability." That is, there is a reduced chance the stapled-lender will attempt to break its commitment to lend because it must also consider the sell-advisor. Presumably, such empathy only occurs because the sell-advisor and the stapled-lender are part of the same bank. In good times, the financial advisor might skew an auction to get both the advisory fee and the lending fees. In bad times, the reverse happens: the bank is less likely to break its commitment to lend because it will not only lose the financing fee, but may also lose the advisory fee. Accordingly, the increased durability of a staple-financed deal, as opposed to a deal using standard financing, is a direct result of the internal conflict at the bank providing both advisory services to the seller and financing to the bidder.

II. THE *REVLON* BACKDROP AND STAPLE FINANCING

A popular view of Delaware's *Revlon* decision is that when the board of directors of a Delaware corporation embarks on a sale of company, the board is under a duty to obtain the highest price for its shareholders.[10] The Delaware Supreme Court has made clear that the only "*Revlon* duty" is to obtain "the highest value reasonably attainable for the shareholders."[11] The court also made clear that "[b]eyond that, there are no special and distinct 'Revlon duties.'"[12] In a sale of control context, selling directors generally

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[9]Cynthia Koons, *Low Rates Make Buyout Debt a Burden*, WALL ST. J., Feb. 19, 2008, at C2. Deutsche Bank alone wrote down $1.11 billion in the value of the leveraged loans, including those used for LBOs, it holds. Carrick Mollencamp et al., *Leveraged Loans Inflict More Pain on Banks Globally; Analysts Predict About $15 Billion in Write-Downs*, WALL ST. J., Feb. 19, 2008, at C2. Even the great Goldman Sachs, which avoided the sub-prime woes of many of its brethren, had leveraged loan exposure equal to 1.1 times its net worth. Kate Kelly & Peter Eavis, *Goldman's Profit Magic May be Fading; Leveraged Loans Likely to Weigh on Earnings; Stock Could Fall Further*, WALL ST. J., Feb. 25, 2008, at C1. Even before the height of the credit crisis, Goldman was staring at $42 billion in leveraged loans on its books, which some estimated would be written down by $1.7 billion. *Id.*

[10]*See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986) (holding that preferential deal protections to a "white knight" bidder, after a hostile bidder has already made an offer, was subject to enhanced scrutiny).

[11]Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989) (citing *Revlon*, 506 A.2d at 182).

[12]*Id.*

have *Revlon* duties, but perhaps the more important question in litigation is whether *Revlon*'s "enhanced scrutiny" applies. For example, when one corporation engaged in a merger that did not involve a change of control, a stock-for-stock merger where the surviving corporation did not have a controlling shareholder, the Delaware Supreme Court indicated that selling directors would find protection in the business judgment rule.[13]

On the other hand, when a change of control does occur, *Revlon*'s enhanced scrutiny generally will apply.[14] A change of control will most likely occur in a stock-for-stock merger where the surviving corporation has a controlling shareholder or whenever there is an all-cash all-shares deal.[15] Some believe the idea is that there is a "control premium" that the target shareholders are giving up and, therefore, the price and the process need to be given a hard look by the court.[16] Likewise, for *Revlon*'s heightened scrutiny regarding defensive measures like lock-ups, break-up fees, no-shop clauses, and rights-of-first-refusal, the Delaware Supreme Court has held that a "plaintiff must show, and the trial court must find, that the directors of the target company treated one or more of the respective bidders on unequal terms."[17]

Here, the point is that where there is staple financing, one is likely to see *Revlon*'s enhanced scrutiny being applied or, at least, arguments that enhanced scrutiny applies. If an acquiring corporation could simply use its stock to effect a stock-for-stock merger, there would be a reduced need to finance anything. The flipside is that one is likely to see financial buyers, such as private equity groups, using financing for various reasons. Staple financing need not be limited to financial buyers, however. Strategic buyers may also wish to finance a bid. In the recent botched deal involving Finish Line's attempted purchase of Genesco, Finish Line was using only $11 million of its own money, while UBS agreed to finance the additional $1.5

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[13]Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del 1990).

[14]Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 928 (Del. 2003) (citing *Revlon*, 506 A.2d at 182). There is an interesting question whether "enhanced scrutiny" applies when a deal has already closed and a plaintiff seeks a monetary judgment against directors of a company with a section 102(b)(7) clause. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). That is, it is not entirely clear that *Revlon*'s enhanced scrutiny is really in practice almost always as an injunction standard, rather than a standard applicable to all cases. In any event, this article does not depend on the answer.

[15]Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Charge of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV 1169, 1175 (2002).

[16]*Id.*

[17]Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989).

billion.[18] Even more recently, Mars needed financing to complete its confectionary mega-deal with Wrigley.[19]

Nevertheless, it makes sense that private equity buyers would be more likely to employ financing and, therefore, more specifically, staple financing. Private equity will not be using stock and will presumably use cash. On the other hand, the private equity players may not be in need of a loan; they might be swimming in cash. Some plausibly argue the difference is that financial buyers are better candidates for financing because "[f]inancial buyers plan to keep the target as a separate legal entity, which makes it . . . possible to default on that debt without endangering other assets that the financial buyer owns."[20] Accordingly, private equity players may be more willing to use financing (and staple financing) because they have a higher tolerance for leveraged risk. Therefore, because taking a company private using cash generally will trigger *Revlon*'s heightened scrutiny and financial buyers will be much more likely to use staple financing, then staple financing will often trigger *Revlon*'s enhanced scrutiny.

III. DELAWARE STAPLE FINANCING DECISIONS

Given *Revlon*'s hard look at going-private deals, it is understandable that staple financing tends to raise eyebrows in M&A transactions. The main concern is the potential that the seller will unfairly favor one bidder over another for reasons unrelated to obtaining the highest value for the target's shareholders. The suspicion is that a sell-advisor may skew an auction in favor of those bidders who will also use the stapled-lender for financing. If the bidder uses the staple financing, then the sell-advisor/ stapled-lender theoretically will obtain a higher fee than if it acted only as the sell-advisor because it will receive both an advisory fee and a financing fee. If the auction is skewed towards a low bidder using staple financing, then the target corporation's board would be on its way to violating its

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[18]Matthew Karnitschnig, *UBS May be on Hook as Deal Goes Bad*, WALL ST. J., Dec. 19, 2007, at C1.

[19]Heidi N. Moore, *Buffett Makes His Selection; Financier Invited to Join Candy Deal by Goldman Sachs*, WALL ST. J., Apr. 29, 2008, at C1.

[20]Paul Povel & Rajdeep Singh, Stapled Finance, at 3-4 (Aug. 1, 2007), *available at* http://finance.wharton.upenn.edu/department/Seminar/2007FALL/micro/paul-povel-micro 09 2007.pdf. Although having some intuitive force, this distinction relies on an empirical statement that may not hold true in all states of affairs, because although a private equity fund may keep the target as a separate legal entity, a typical private equity fund might manage thirty or forty companies. Likewise, a strategic buyer might hold a target as a wholly-owned subsidiary. The question is, thus, not simply whether a target is kept as a separate legal entity but who owes money in the event of default.

Revlon duty to obtain the highest price. Even if the use of staple financing alone does not trigger *Revlon* liability, this perceived conflict certainly creates a potentially thorny situation that adds to the mix of facts surrounding an alleged breach of the duty of loyalty.

The misalignment of interests between the seller and the sell-advisor/stapled-lender is amplified by the fee structure of deals (at least in good times), because the financing fees may exceed advisory fees: "Typical fees for advising on a corporate sale are about 0.5 percent of the transaction's value. The lead arranger of loans for a leveraged buyout can make 1.3 percent to 1.5 percent of a loan's value . . . ."[21] Accordingly, the fear is that the sell-advisor/stapled-lender might, as an institution, prefer to sacrifice the quality of advice in order to make the much larger financing fees.

There have been no Delaware cases, so far, that have reached a decision on the merits regarding the propriety of staple financing. But the cases that have addressed a situation where staple financing has been used have expressed discomfort at the apparent conflict. Indeed, Vice Chancellor Strine's dicta in *In re Toys "R" Us, Inc. Shareholder Litigation*[22] brought staple financing into the limelight.[23] In a preliminary injunction context, Vice Chancellor Strine expressed his discomfort with the practice:

> [The board's] decision was unfortunate, in that it tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms. Far better, from the standpoint of instilling confidence, if First Boston had never asked for permission, and had taken the position that its credibility as a sell-side advisor was too important in this case, and in general, for it to simultaneously play on the buy-side in a deal when it was the seller's financial advisor. In that respect, it might have been better, in view of First Boston's refusal to refrain, for the board of the Company to have declined the request, even

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[21] Christine Harper & Julia Werdigier, *"Stapled" Loans Create Potential Conflicts for Merger Advisers*, BLOOMBERG.COM, Oct. 23, 2005, http://www.bloomberg.com/apps/news?pid=10000006&sid=aNS.Y5u9qCb8&refer=home; *see also* Robert Dunn, *Booming LBO-Firm Business Is a Boon to Investment Banks*, WALL ST. J., Aug. 18, 2004, at C4 (explaining the advantages to banks in garnishing large fees by working with LBO groups).

[22] 877 A.2d 975 (Del. Ch. 2005).

[23] *Id.* at 1006.

> though the request came on May 12, 2005, almost two months after the board had signed the merger agreement.[24]

The Vice Chancellor's discomfort has, in many ways, been blown out of proportion. First, even given the importance of dicta in Delaware decisions,[25] *Toys* did not involve pure staple financing. The *Toys* board allowed Credit Suisse to finance the bidder only after a merger agreement had already been signed with the winning bidder.[26]

Second, in the footnote that followed, Vice Chancellor Strine further hedged against the full extension of his dicta:

> By stating this, I do not want to be perceived as making a bright-line statement. One can imagine a process when a board decides to sell an entire division or the whole company, and when the board obtains a commitment from its financial advisor to provide a certain amount of financing to any bidder, in order to induce more bidders to take the risk of an acquisition. These and other scenarios might exist when roles on both sides for the investment banker would be wholly consistent with the best interests of the primary client company. In general, however, it is advisable that investment banks representing sellers not create the appearance that they desire buy-side work, especially when it might be that they are more likely to be selected by some buyers for that lucrative role than by others.[27]

Even though *Toys* warned against the use of staple financing in general, Vice Chancellor Strine added that it was not his job to "police the appearances of conflict that, upon close scrutiny, do not have a causal influence on a board's process."[28] Further echoing the footnote, Vice Chancellor Strine explained at a California conference that *Toys* was really a warning against a case of bankers chasing fees when it had no benefit to the seller.[29]

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[24] *Id.*

[25] Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997) (arguing Delaware courts often give "sermons" without imposing liability as a way to create corporate norms or best practices).

[26] *In re Toys "R" Us. Inc.*, 877 A.2d at 1005-06.

[27] *Id.* at 1006 n.46.

[28] *Id.*

[29] David Marcus, *Wilmington on the Pacific*, CORP. CONTROL ALERT 11 (Mar. 2006). Also, Vice Chancellor Strine appeared to backtrack on his *Toys* dicta at the Tulane Corporate Law

Regardless of whether liability will automatically attach to a deal involving staple financing, risk of litigation certainly remains. In the lesser-known and more laconic case of *Ortsman v. Green*,[30] Vice Chancellor Lamb granted plaintiffs' motion to expedite and allowed discovery for claims that staple financing negatively affected the sale process.[31] UBS acted as advisor to the seller, and then asked the seller if it could provide debt financing to potential acquirers.[32] The company did, however, bring in Credit Suisse to provide a fairness opinion.[33] The complaint alleged that "UBS advised the Adesa board not to pursue an indication of interest from a strategic buyer that UBS believed would not be interested in a leveraged transaction and, thus, would not be a source for it of fees from debt financing."[34] Vice Chancellor Lamb allowed expedited discovery to proceed, but the case settled before trial.

Once in *Revlon*-land, staple financing is not always a problem, however. In a *Revlon* review of a going-private transaction involving Lear Corp., staple financing produced beneficial litigation results for the target because it was offered to, but not used, by the winning bidder. In contesting its treatment as a thwarted bidder of Lear, claims of unfairness were undercut by the availability of staple financing from the target's advisor.[35] Interestingly, staple financing seems to enhance the perception of equal treatment among bidders when it is *offered but not used by* the winning bidder, as opposed to when it is not offered at all. But when it is *offered and used*, it enhances the appearance of unequal treatment, as opposed to when it is not offered at all.

IV. STAPLE FINANCING AND ITS DEVOTEES

Staple financing's devotees offer plausible reasons why staple financing can have beneficial results for the target and the target shareholders. Some of these benefits only arise where staple financing is optional, while others depend on the target requiring the use of staple financing. Some of the benefits include:

Institute. He was quoted as saying, "The idea that you get someone who's unconflicted and has no experience is an idiotic notion." Sorkin, *supra* note 1; *see also* David Marcus, *Banking Banter Breaks Out at Tulane*, CORP. CONTROL ALERT 21 (May 2006) (discussing Vice Chancellor Strine's displeasure with the use of stapled financing because it creates the appearance of impropriety).

[30]No. 2670-N, 2007 WL 702475 (Del. Ch. Feb. 28, 2007) (Lamb, V.C.).

[31]*Id.* at *1-2.

[32]*Id.* at *1.

[33]*Id.*

[34]*Ortsman*, 2007 WL 702475, at *1.

[35]*In re* Lear Corp. S'holder Litig., 926 A.2d 94, 106 (Del. Ch. 2007) (Strine, V.C.) (noting that the bidder could have accepted the stapled financing package offered by seller's advisor).

- *Creates a Price Floor*: Staple financing provides a price floor by price-signaling the target's belief about how much leverage the seller can support.[36] The "price-signaling" effect could also reduce the variability of bids being submitted, thereby reducing the amount of time spent by bidders who would not win, which then increases overall M&A market efficiency.[37]

- *Speeds up the Auction Process*: With financing already in place, the bidders need not take the added time to line up their own financing before making bids.

- *Encourages a Competitive Auction*: By offering staple financing to all bidders, the playing field among different kinds of bidders is leveled. In general, strategic buyers may be able to offer higher bids than financial buyers because strategic buyers more likely can realize synergies. Depending on these perceived synergies, staple financing makes it more likely that financial buyers will be able to compete against strategic buyers in offering the same premium to the target's unaffected market price. Thus, staple financing can increase the price by increasing competition. For example, in the recent TXU deal, Credit Suisse offered to finance any other bidder that would be willing to top the TPG/KKR bid.[38] Likewise, among several bidding financial buyers, staple financing reduces the influence of one bidder locking up exclusive financing with a group of banks of which there may be few capable of financing such a deal.

- *Reduces Post-Signing Uncertainty*: Staple financing reduces the winning bidder's ability to negotiate down the price before closing with the threat that the financing is not available.[39]

- *Provides an Apples-to-Apples Comparison of Bids*: When a target requires bidders to use staple financing, a legitimate reason can be because the seller wants to be able to evaluate the bids without

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[36]Ronald Cami, *Fear of Commitment*, THE DEAL, May 8, 2006, at 21.

[37]Richard Hall, *Stapled Finance Packages Under Scrutiny*, IFLR1000 2006, http://www.iflr.com/Article.aspx?ArticleID=1984558 (last visited on Mar. 29, 2009).

[38]Sorkin, *supra* note 1.

[39]Bruce Klempner et al., *Case Study: Selling Neiman Marcus*, 12 HARV. NEGOT. L. REV. 235, 246-47 (2007) (noting that none of the bidders ultimately chose the staple financing package).

considering differing financing risks. If bidder A comes in with a fully negotiated and presyndicated deal commitment versus bidder B who comes in with a letter from a bank saying the bank would be willing to lend subject to additional due diligence, then even if bidder A's bid is lower, the seller may take bidder A. Requiring all bidders to use staple financing creates certainty in evaluating the bids by reducing variability. Certainty is valuable. Not everyone is happy with forced staple financing, though. Nelson Peltz reportedly complained that the Special Committee of Wendy's insisted that any financed bid must use staple financing.[40] Even with optional staple financing, sellers may use staple financing to test the waters and determine the estimation of the bids different players could likely make.[41] Such a method would also decrease the possibility of leaks by limiting the number of banks involved.

Staple financing's promoters also argue that the conflict is itself blown out of proportion. For example, Kevin Miller acknowledges the potential conflicts, but concludes that it is hard to "construct a plausible scenario" where bankers would have an opportunity to keep the board from accepting a topping bid.[42] Richard Hall also says: "In most auctions, the question of who is the winning bidder is clear, and it is only in the rare situation that the advice of the seller's financial advisor will be material to the decision of the seller."[43] At first glance, these appear to be very odd statements. Why else would a seller hire a bank to advise on a merger if the advisor could not possibly sway the board to pick one deal over another?

One answer may be that the advisors do not actually do much advising when it comes to picking one bid over another. Perhaps, the advisor's role has become merely one of concierge for someone who already knows what restaurant she wants to go to. Management is sophisticated, and they hire the bank not for advice in deciding between bids but for their contacts and knowledge of prospective bidders.

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[40]Greg Johnson, *PE Briefly Noted*, DAILY DEAL, Aug. 29, 2007, *available at* 2007 WLNR 16818272.

[41]When the staple financing is optional, staple financing loses some of its stigma not only in Delaware case law but within the press. In Thomson's sale of its education division, J.P. Morgan offered staple financing, but two private equity firms opted out. Andrew Willis, *Stapled Financings Go the Way of the Dodo, and So Do Takeovers Deals*, GLOBE & MAIL (Ont.), Nov. 9, 2007, at B11.

[42]Kevin Miller, *In Defense of Stapled Financing*, M&A LAW., Jan. 2006, at 1, 1.

[43]Hall, *supra* note 37.

Likewise, it is not entirely clear that the investment banks are foisting the financing upon unwitting or unwilling sellers. In order to get the advisory mandate, the banks may have been using their balance sheets as a way to convince the target to retain them for the advisory position. Accordingly, historically commercial banks like Bank of America, J.P. Morgan Chase, and Wachovia likely saw a boom in advisory mandates because of staple financing. Conversely, the likely losers in the advisory mandate league tables were advisory firms that typically do not provide financing, like Lazard.

The advisory mandate interpretation of staple financing is not farfetched. Recently, in a buy-side advisory context, Merrill Lynch reportedly was fired as one of two advisors to Vale, the world's second largest mining company, after Merrill decided not to participate in the financing of Vale's potential $90 billion acquisition of Xstrata, a Swiss mining company.[44] Of course, buy-side advising likely is more contingent on also providing financing, but the same principle would apply to a target that is committed to selling itself. On the sell-side, in the sale of Home Depot Supply, Goldman Sachs replaced Lehman Brothers as the sell-advisor when Lehman balked at providing the staple financing on the original terms.[45]

Contrary to Miller and Hall's view, if the sell-advisor's main job is simply to find prospective bidders, then there may be ways to subtly skew the auction in favor of those bidders using the stapled-lending. In Delaware, there is no one blueprint for selling a company.[46] Neither a full-blown auction for the best price or a presigning market check is necessary in every possible circumstance. Often the seller will solicit one bid only and then sign an agreement with a full battering of deal protection devices, such as no-shop and no-solicitation clauses, rights-of-first-refusals, and break-up fees. Delaware courts have routinely held that these devices, when not preclusive of other bids or other equitable considerations, are perfectly legal.[47] The idea may be that the deal protection devices serve as

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[44]Lina Saigol, *Vale Drops Merrill as Lead Advisor*, FIN. TIMES (London), Feb. 3, 2008, *available at* http://www.ft.com/cms/s/0/5f3895d8-d28f-11dc-8636-0000779fd2ac.html?nclick_check=1ft.

[45]Andrew Ross Sorkin & Michael J. de la Merced, *Home Depot Said to Cut Price of Supply Unit by $2 Billion*, INT'L HERALD TRIB., Aug. 27, 2007, at 11.

[46]Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286-87 (Del. 1989).

[47]*See, e.g.*, *In re* Toys "R" Us, Inc., S'holder Litig., 877 A.2d 975, 980, 1017 (Del. Ch. 2005) (holding that "match rights" provisions are "a common contractual feature," and also upholding a no-shop provision and a 3.75% termination fee); McMillan v. Intercargo Corp., 768 A.2d 492, 505-06 (Del. Ch. 2000) (holding that no-shop and termination fee provisions were "standard" deal protection provisions that were hardly indicative of a *Revlon* or *Unocal* breach); *In re* IXC Commc'ns Inc. S'holders Litig., Nos. 17,324 & 17,334, 1999 WL 1009174, at *6 (Del. Ch.

inducements for an initial bid and the court decisions acknowledge the fact that generally no one wants to be a stalking horse bidder (unless it is worth one's while to do so). There are even a few Delaware cases that seem to state that the use of deal protection devices without a showing of disloyalty by the defendant will be reviewable under the business judgment rule.[48] Delaware courts have intimated that as long as those deal protection devices are not preclusive of other bids, then the post-signing market check is the announcement of the deal.[49] If other bidders want to bid, they will not be shy about it. The players in the M&A world are not, as one Vice Chancellor put it, a "cotillion of the reticent."[50] Accordingly, if the sell-advisor's job is to find a friendly bidder, who then enters into a merger agreement using staple financing, and the deal involves protective devices and no active survey of the market, then it is not irrational to think the sell-advisor can skew the auction somewhat, given the decreased likelihood that a second bidder will emerge.

Additionally, the sell-advisor's role in providing a fairness opinion complicates the staple financing landscape. The sell-advisor/stapled-lender will probably have a Chinese wall[51] within the bank, but sell-advisors are

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Oct. 27, 1999) (stating that no-shop provisions are "common in merger agreements and do not imply some automatic breach of fiduciary duty"); Goodwin v. Live Entm't Inc., No. 15,765, 1999 WL 64265, at *23 (Del. Ch. Jan. 25, 1999), *reprinted in* 24 DEL. J. CORP. L. 1084, 1126 (1999) ("Although the merger agreement contained a 3.125% termination fee, this type of fee is commonplace and the amount is within the range of reasonableness approved by this court in similar contexts.").

[48]State of Wis. Inv. Bd. v. Bartlett, No. 17,727, 2000 WL 238026, at *9 (Del. Ch. Feb. 24, 2000), *reprinted in* 26 DEL. J. CORP. L. 469, 487 (2001) ("[I]n the absence of breach of fiduciary duty in agreeing to the lock-up devices [such as no-shops], these provisions are reviewable as business judgments and are, thus, granted deference."); *In re IXC Commc'ns*, 1999 WL 1009174, at *10 ("[I]n the absence of a showing of disloyalty or lack of care in agreeing to the termination fee, these provisions are reviewable as business judgments and are, thus, granted deference."); *see also McMillan*, 768 A.2d at 506 (holding that plaintiff failed to state a claim for breach of duty of loyalty, premised on *Revlon*, where board negotiated "standard" 3.5% termination fee, no-shop provision, and where board did not refuse to consider later bids).

[49]*Barkan*, 567 A.2d at 1286-87; *see also* McGowan v. Ferro, 859 A.2d 1012, 1034 (Del. Ch. 2004) ("[T]he failure to conduct a market check, by itself, is insufficient to state a claim for breach of fiduciary duty."), *aff'd mem.*, 873 A.2d 1099 (Del. 2005).

[50]*In re Toys "R" Us Inc.*, 877 A.2d at 1006.

> [P]layers in the American M&A markets . . . are not like some of us were in high school. They have no problem with rejection. The great takeover cases of the last quarter century . . . all involved bidders who were prepared, for financial advantage, to make hostile, unsolicited bids. Over the years, that willingness has not gone away.

Id. at 1007.

[51]I understand that the use of the term "Chinese Wall" is, according to some, culturally offensive. I do not mean to seem insensitive. I was under the apparently mistaken impression that because the Great Wall of China was "Great," the term "Chinese Wall," when used to signify an ethical boundary, was meant as a compliment. Evidently, however, Ghengis Khan got around the

now shrewdly bringing in a second financial advisor to mitigate the conflict.[52] Since *Smith v. Van Gorkom*,[53] sellers are virtually required to obtain a fairness opinion. Although *Van Gorkom* states that a fairness opinion is not required under Delaware law, the court made it obvious that the board needed some kind of financial analysis prepared by someone outside the firm in order to rely on the liability shelter of section 141(e) of the Delaware General Corporation Law.[54] Section 141(e) basically provides that the board shall be "fully protected" when they rely upon information from an officer or expert.[55]

The sell-advisors can, of course, provide such an opinion, but this practice has become increasingly frowned upon, largely because of the sell-advisor's contingent fees. For a corporation that is making a kind of "I'm selling regardless, so give me your best offer" sale, the contingent fees make sense. After all, you do not tip the concierge if she cannot get you into the restaurant. Accordingly, contingent fees for sell-advisors have been affirmed by Delaware courts on numerous occasions.[56] Yet, contingent fees as compensation for a bank providing a fairness opinion arguably makes no sense.

Chancellor Chandler recently excoriated a target when the sell-advisor also acted as the advisor for the special committee that was set up to evaluate the deal: "Rather than retain separate legal and financial advisors, the Special Committee chose to use the legal and financial advisors already advising [the company]. This alone raises questions regarding the quality and independence of the counsel and advice received."[57] In response, banks have tried to ameliorate any conflict by bringing in a second bank to provide a fairness opinion.

On the other hand, the fairness opinion conflict might be seen as less of an issue than staple financing given what some perceive as the flaccidity of fairness opinions. Fairness opinions that say a deal is unfair are hard to

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Great Wall of China, which renders the use of the term in the investment banking context somewhat tongue-in-cheek. In an earlier draft, I attempted to use the term "Berlin Wall," thinking that wall—for better or worse—was more effective at its intended purpose, but that just confused everyone.

[52]Cami, *supra* note 36, at 21.

[53]488 A.2d 858 (Del. 1985).

[54]*Id.* at 876-78, 881 n.22 (citing DEL. CODE ANN. tit. 8, § 141(e) (1985)).

[55]*Id.* at 874-75 n.15.

[56]Delaware law recognizes that it is not unlawful to compensate financial advisors on a contingent basis. *See, e.g.*, *In re Toys "R" Us Inc.*, 877 A.2d at 1005 (holding that contingency fee arrangements for investment bankers "ha[ve] been recognized as proper by our courts"); *In re* MONY Group Inc. S'holder Litig., 852 A.2d 9, 22 (Del. Ch. 2004); *In re* Vitalink Commc'ns Corp. S'holders Litig., No. 12,085, 1991 WL 238816, at *10 (Del. Ch. Nov. 8, 1991), *reprinted in* 17 DEL. J. CORP. L. 1311, 1331-32 (1992), *aff'd mem. sub nom.* Grimes v. John P. McCarthy Profit Sharing Plan, 610 A.2d 725 (Del. 1992).

[57]*In re* Tele-Commc'ns., Inc. S'holders Litig., No. 16,470, 2005 WL 3642727, at *10 (Del. Ch. Jan. 10, 2006) (Chandler, C.), *reprinted in* 31 DEL. J. CORP. L. 1162, 1179 (2006).

come by. Also, the fairness opinion will often rely entirely on the documents and figures management has provided, and similarly a bank brought in to complete a fairness opinion often will not perform its own due diligence. In the recent case involving the scuttled buyout by J.C. Flowers of Sallie Mae, the attorney for J.C. Flowers admitted: "A fairness opinion, you know—it's the Lucy sitting in the box: Fairness Opinions, 5 cents."[58] Indeed, note the second bank did not insulate the defendant from scrutiny in *Ortsman v. Green* when in the staple financing context.[59]

V. STAPLE FINANCING REMOVERS

One of the main casualties of the recent credit crisis has been LBO deals. One commentator in the press noted that part of the problem is that banks have been willing to pull staple financing packages, which has led to jokes that "such offers should now be called 'paper clips,' because they are easily detachable."[60] Interestingly, with all the talk about staple financing, there has been no attempt to show that staple financing is any more or less durable than standard financing. Again, durability is simply a measure of a deal's likelihood of closing. One would, for example, expect that staple financing would reduce the likelihood that a Material Adverse Change (MAC, or when used to describe the Material Adverse Effect clause, a MAE) would be called by a lender.[61]

A. *MAC Clauses*[62]

The article's point is not whether MACs are more or less likely to actually occur with staple financing, but simply whether MACs are less likely to be called. A typical MAE clause will state that a condition to closing is the nonoccurrence of an MAE. Exactly what constitutes a MAE has been the subject of considerable debate. Courts tend to look at the

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[58]Transcript of Scheduling Conference at 18, SLM, Corp. v. J.C. Flowers II L.P., No. 3279-VCS (Del. Ch. Oct. 22, 2007).

[59]*See supra* notes 30-34 and accompanying text.

[60]Posting of Dennis Berman & Dana Cimilluca to Deal Journal, http://blogs.wsj.com/deals/2007/09/10/another-deal-bites-the-dust-insight-auction-pulled/ (Sept. 10, 2007, 13:40 EST); *see also* Willis, *supra* note 41, at B11 (noting the downturn in staple financing and deals generally).

[61]One writes a MAE clause, but one calls a MAC.

[62]A full review of MAE clauses is not relevant here, so this section will be limited to a topical analysis.

relative size of the event compared to the company's overall financial situation.[63]

In a notable case, the Delaware Court of Chancery added a temporal element:

> [E]ven where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.[64]

Both the relative size of the change, as well as the seemingly magical words "durationally significant," are fact specific inquiries and, thus, are not subject to any one definition. Accordingly, using an MAE defense is exceptionally risky, especially given the size of the deals and the possibility that the court will specifically enforce the deal, as occurred in *In re IBP, Inc. Shareholders Litigation*[65]or simply disavow the deal if an MAE occurred. From the perspective of each party (i.e., the bidder, seller, the sell-advisor, and the lender), it is often far better to negotiate down the deal than employ an all-or-nothing litigation strategy. Likewise, as with any specific performance case, the seller presumably cannot sell the company while that litigation is pending. As such, the data set concerning merger cases involving MAEs is more anecdotal than statistically significant.

Nevertheless, the three high-profile break-up litigations from the past year have all involved the now famous MAE clause.

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[63]Frontier Oil Corp. v. Holly Corp., No. 20,502, 2005 WL 1039027, at *35-36 (Del. Ch. Apr. 29, 2005), *reprinted in* 30 DEL. J. CORP. L. 993, 1055-58 (2005) (finding that an unanticipated litigation fee of $15 million to $20 million did not qualify as a MAC because the enterprise value of the company was about $338 million); *In re* IBP, Inc. S'Holders Litig., 789 A.2d 14, 71-72 (Del. Ch. 2001) (holding that one time charge of $108 million and sixty-four percent drop in operational earnings were immaterial given the $4.7 billion price tag for the merger); *see also* JPA, Inc. v. USF Processors Trading Corp., No. 3:05-CV-0433P, 2006 WL 740401, at *4 (N.D. Tex. Mar. 15, 2006) ("While not defined in the SPA, the Court finds that a minimum 10% effect is materially adverse.").

[64]*In re IBP, Inc.*, 789 A.2d at 68.

[65]*Id.* at 82-84.

- *Genesco, Inc. v. Finish Line, Inc.*:[66] In Tennessee's Court of Chancery, Finish Line and UBS attempted to back out of a deal to acquire Genesco.[67] UBS advised the acquirer and Goldman Sachs advised the target.[68] Finish Line and UBS claimed that Genesco had suffered an MAE, that Genesco committed securities fraud, and that Genesco fraudulently induced Finish Line and UBS to enter into the deal.[69] The judge rejected all three defenses and ordered specific performance.[70]

- *United Rentals, Inc. v. RAM Holdings, Inc.*:[71] In Delaware, Cerberus successfully challenged its obligations to go ahead with its planned acquisition of United Rentals, who was advised by UBS.[72] The court held that the plaintiffs had not sufficiently demonstrated that specific performance was an available remedy.[73] This case also involved an MAE provision.

- *SLM Corp. v. J.C. Flowers II L.P.*:[74] In Delaware, SLM attempted to force J.C. Flowers to pay a break-up fee after J.C. Flowers failed to close.[75] Again, the case involved a claimed MAE and settled.

Notably, none of the big three litigations, all of which involved MAEs, were staple financed.

B. *The Double Fee Creates the Conflict and the Durability*

As noted in Part II, it is the fee structure of deals that creates the sell-advisor/stapled-lender conflicts.

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[66]No. 07-2137-II(III) (Tenn. Ch. Dec. 27, 2008) (enforcing specific performance).

[67]*Id.*, slip op. at 1-2.

[68]*Id.*, slip op. at 5-6.

[69]*Id.*, slip op. at 9-10.

[70]*Genesco, Inc.*, No. 07-2137, slip op. at 3.

[71]937 A.2d 810 (Del. Ch. 2007) (declining to enforce specific performance).

[72]*Id.* at 819, 836.

[73]*Id.* at 845.

[74]Verified Complaint at 1, SLM Corp. v. J.C. Flowers II L.P., No. 3279-VCS (Del. Ch. Oct. 8, 2007); Andrew Ross Sorkin & Michael J. de la Merced, *Sallie Mae Settles Suit Over Buyout that Fizzled*, N.Y. TIMES, Jan. 28, 2008, at C1 (reporting that Sallie Mae settled with banks providing new credit lending facility).

[75]Verified Complaint, *supra* note 74, at 1.

> The underwriting [stapled-lending] fees range from 1.3% to 1.5% of the amount financed, and the [sell-]advisory fees are approximately 0.5% of the transaction's value. The underwriting [stapled-lending] fees can account for as much as 80% of the total fees that the investment bank collects, with the advisory fees representing about 20% of the investment bank's total fees.[76]

The problem with the incentive structure is obvious. Assuming this fee structure, given a $10 billion deal, the sell-advisor stands to make a fee of $50 million. If the sell-advisor can also provide the staple financing, the sell-advisor can add $130 to $150 million for a total of $180 to $200 million in fees for a single deal. The fourfold increase becomes problematic when there is another bidder who offers $10.5 billion and will not use staple financing. Here, the sell-advisor/stapled-lender will only make $52.5 million, even though the difference in the overall bid is $500 million. That is a powerful incentive to skew the auction, assuming that skewing the auction is possible. All of this presupposes, however, that the deal goes through and the stapled-lender can actually syndicate the loans or sell the bonds for an amount equal to what they lent minus the 1.3% to 1.5% financing fee.

On the other hand, the fee structure has a different effect when the loan values tank, such as when credit liquidity dries up. One of the reasons why one would expect to see a reduction in MAEs and increased durability with staple financing is the exact same fee structure and the exact same conflict produced by the sell-advisor/stapled-lender's fees. For example, if the value of the loans for a fully financed $10 billion acquisition were to drop by 0.5% and the bank was forced to hold the loans, then the sell-advisor/stapled-lender would still make $130 to $150 million and so on until the loan loss exceeds the amount of the advisory fee. Thus, the advisory fees would act as a buffer for any losses the bank would accrue on the lending side. Likewise, the advisory fee might alter the efficiency of breaching and paying a reverse break-up fee. Accordingly, one would expect that a stapled-lender would be more likely to deliver the financing at closing when things go bad in credit markets than a standard lender with no sell-side

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[76]Dennis J. Block, *Public Company M&A: Recent Developments in Corporate Control, Protective Mechanisms and Other Deal Protection Techniques*, *in* CONTESTS FOR CORPORATE CONTROL 2008: CURRENT OFFENSIVE & DEFENSIVE STRATEGIES IN M&A TRANSACTIONS, at 185 (PLI Corp. Law & Practice, Course Handbook Series No. 13,964, 2008).

affiliations. Thus, staple financing becomes more durable than standard financing in poor credit markets.

C. *Idiosyncratic Results Complicating Stapled Durability*

There are a number of assumptions and simplifications here. First, it is not clear whether the stapled-lender's 1.3% to 1.5% fee comes as an actual upfront fee from the bidder or whether the stapled-lender is simply taking part of the spread for facilitating the loan. Second, the stapled-lender may be making additional fees not only when it turns around and sells the debt (accounted for by a spread), but would also make money by charging fees to its own clients who are buying the debt. Third, there may be an opportunity-cost not accounted for in my simplified scheme. If the bank can use the money and its people somewhere else to produce a higher rate of return, this would further reduce the value of the already reduced lending fee. Of course, these concerns merely change the arithmetic and not the general principle of durability.

Further, there may be internal dynamics within the firm that would lead to varying results at different banks. For example, some banks may allocate bonuses not based on how the entire sell-advisor/stapled-lender institution does. The bonuses may be allocated by practice group. The stapled-lending department, with a better opportunity-cost elsewhere, might be less willing to take on any pain for the sell-advisor department if the lending department's bonuses are not tied to how well the sell-advisor department does. Likewise, a particularly powerful managing director who runs the sell-advisor side of the deal might force the stapled-lender to take some pain, maybe even at a reduction in net present value, if his or her bonus is only tied to the sell-advisor department. These types of firm-specific, departmental power struggles could lead to idiosyncratic results.

Similarly, if the sell-advisor or the stapled-lender has a stronger relationship with either the target or the bidder, the results would be unpredictable. If the sell-advisor has done all of the work for the seller in the past and will continue to do so after the merger (which may seem unlikely considering they are being bought), the sell-advisor may want the stapled-lender to take some pain in return for expected future advisory fees and, thus, the long-term good of the entire bank. The same is true of the stapled-lender when the stapled-lender has a continuing relationship with a financial sponsor and the stapled-lender wants to get out of or stay in a deal.

Although it was not a stapled-lending deal, the recent Acxiom transaction is instructive here. ValueAct Partners and Silver Lake Partners backed out of a deal to acquire Acxiom for $2.25 billion.[77] Both agreed to pay a portion of the break-up fee to get out of the deal.[78] Three banks were providing financing: UBS, J.P. Morgan, and Bank of America.[79] UBS and J.P. Morgan agreed to put up the majority of the break-up fee, and in so doing agreed to share the pain, in part, because they would then not have to hold on to the loans.[80] Bank of America refused to pay for any part of the break-up fee.[81] One can reasonably suspect that Bank of America will not be the first choice for financing any future ValueAct or Silver Lake bids.

Additionally, the idea that staple financing is more durable simply based on the sell-advisor fee cushion will change depending on the initial fee structure. The staple financing package may already account for the sell-advisor fee. That is, the stapled-lender may be able to offer the best financing available because it is willing to forfeit some of its fee or some of the spread, since it will make up for the loss with the sell-advisor's fee. In their finance article, Professors Paul Povel and Rajdeep Singh "show" that "the investment bank providing the stapled finance expects *not* to break even . . . . [S]tapled finance that benefits the seller can be arranged if it is possible to compensate the investment bank for its expected loss, for example with an up-front fee, or by retaining it for other fee-based services."[82] Compensation through an "upfront fee" would seem to be irrelevant for optimal staple financing because this could be done with any financer being paid by the bidder. Indeed, if the seller pays the upfront fee in staple financing, then analytically there is no difference because the bidder is buying the company and, therefore, pays anyway. Nevertheless, it could be that the stapled-lender can provide more aggressive financing because it will be able to make up for any loss through sell-advising. If this is true, then the sell-advisor's fee would act as less of a buffer, or no buffer at all, in the event of a major credit crisis, as compared to an independent lender.

This wrinkle comports with the idea of the advisory mandate. If it is true that the sell-advisor/stapled-lender is using staple financing as a way to get the advisory mandate, they may well have expected to take a loss on the lending in order to obtain the advisory fee. Lending would become a loss-

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[77]Andrew Ross Sorkin, *Acxiom Shows Breaking Up is Costly*, N.Y. TIMES, Oct. 10, 2007, at C11.

[78]*Id.*

[79]*Id.*

[80]*Id.*

[81]Sorkin, *supra* note 77, at C11.

[82]Povel & Singh, *supra* note 20, at 2.

leader for the advisory business. If, for example, the lenders were expecting to take a 0.2% hit on the lending by offering favorable terms, they could make that up with the 0.5% in fees. Indeed, they might only get the 0.5% in advisory fees if they were willing initially to commit to providing the staple financing at a 0.2% loss. If so, then an exceptionally peculiar result emerges. In good times, the sell-advisor would have an incentive to *skew the auction towards those bidders who would not use the staple financing.*[83] This could lead to a *Revlon* violation, but it would entail the reversed skewing of the auction away from those bidders using the staple financing, even though the bidder using the staple financing might be willing to offer the highest bid.

The degree of the sell-advisory fee cushion directly depends on the degree of the decline in loan value. If there is a deal fully financed by loans whose value has dropped to eighty-five cents on the dollar, even a 2% advisory fee might be a drop in the bucket. The advisory fee would provide some added buffer, but the buffer may be less than significant in many circumstances where loan values have dropped precipitously. Nevertheless, the point of this article is not that staple financing prevents deal break-ups; it merely makes a break-up less likely.

The limited conditionality of the loans during the stapled-financing period also might have an effect, e.g., covenant-lite,[84] vague MACs, no market MACs, PIK toggle remedies,[85] and SunGard-like limitations on representations that count as conditions precedent to financing.[86] An unresolved question is whether staple financing typically would have more or less conditionality than independent financings during the same period. Ronald Cami has argued that sellers should be wary of staple financing because it may come with an increased number of lending conditions.[87] He reasons a bank may not wish to conduct proper due diligence when there is a possibility that it will not get to provide the financing. Cami seems to think there would be more conditionality, but it seems logical that there would be less conditionality because the stapled-lender may be seeking a mandate for the advisory business. Further, there is no principled reason why there

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[83]Hats off to Professor Rock for this very clever insight.

[84]*See* Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 24 (2008) (defining "covenant-lite" loans as "debt issued without standard loan conditions relating to the financial performance of the corporate borrower").

[85]*Id.* (defining "payment in kind" toggle notes as "giv[ing] the borrowers the option to defer paying interest in the form of cash until the issued bonds mature[]").

[86]*See* Andrew Bettwy, *The SunGard Approach*, DAILY DEAL, Oct. 29, 2007, *available at* 2007 WLNR 21173702.

[87]Cami, *supra* note 36, at 21.

would be any more conditions than a bidder's independent lender, because the independent lender is no more assured of financing the deal than a stapled-lender. Indeed, the sell-advisor will conduct its own due diligence in advising the company on what kind of offer it could expect or what would be fair. Thus, it would seem like less initial outlay for the stapled-lending institution as a whole, so there should be fewer conditions.

VI. CONCLUSION

In good credit markets, staple financing provides numerous benefits to the seller. The problem is that the bank is conflicted, which might lead to a reduced price for the target's shareholders. Previous analyses and the only two cases to squarely address the issue have focused on the negative aspects of this conflict. Some have attempted to defend staple financing and have prescribed the use of "Chinese walls" and fairness opinions, while downplaying the sell-advisor's ability to skew the auction. Given the ability for targets to select the first buyer, the sell-advisor may have substantial influence, if not in picking amongst bids, then in picking the first bidder. In good times, one potential solution Delaware courts might explore would be to require a more robust market check than the mere announcement of a ripe deal loaded with deal protections.

On the other hand, in a bad credit market the conflict may actually be beneficial. The benefits of staple financing in a bad credit market are based upon the belief that the stapled-lender will be more likely than others to provide the financing at closing. The only reason the stapled-lender is more likely to provide the financing at closing than a bidder's independent lender is because the sell-advisor/stapled-financer is conflicted. The stapled-lender will not only have to account for its lost lending fees balanced against the loss on actually trying to sell the loans, but it will also have to account for potentially losing the sell-advisor fee and the advisory relationship if the deal breaks down. If the deal breaks down because of the stapled-lender's inability to close, the sell-advisor may be so conflicted it will be forced to disengage and the bank will also lose that fee. This result would suggest that the sellers should have no problem with the conflict in bad times. Nevertheless, there are complications to this analysis. Some of these problems relate to the lack of information concerning the inner-workings of the banks. Some problems relate to a lack of information on how banks are pricing the staple financing.

Indeed, if staple financing is only beneficial because it can be more aggressive than independent lending, one might expect that staple financing has contributed to the unmarketable leveraged loans sitting on banks' balance sheets. The real concern would not be with the target, which is what

Delaware merger law naturally focuses on, but with the banks themselves. In the future, the banks might shy away from providing staple financing even when the credit market rebounds. On the other hand, stapled-lenders and independent lenders may simply increase the "financing out" conditions present. If anything, banks may recognize that the internal conflict makes it more likely they will be stuck with financing commitments because of the reputational costs (if such a quaint idea still exists on Wall Street) to its sell-advisory business.

Also, credit may still be available, but it can come from sources other than traditional banks. In the Goodman Global deal, Goldman Sachs acted as the sell-advisor and staple-lender in concert with J.P. Morgan. J.P. Morgan backed out of the stapled-lending. The private equity sponsor, Hellman & Friedman, then secured financing from the GSO and Farallon hedge funds.[88] Very recently, Mars secured some of its financing for the Wrigley acquisition from Warren Buffett.[89] It may well be that the middle-men investment banks will increasingly be shut out of deals in the future. The private equity sponsors probably do not need the buy-side advisory help and if the ultimate investors in the leveraged loans (e.g., hedge funds or an insurance man from Omaha) directly provide the financing, then staple finance may well have passed into history.

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[88]Matthew Sheahan, *Will Hedge Funds Cut Out the Middleman?*, BANK LOAN REP., Nov. 5, 2007, at 1, *available at* 2007 WLNR 21986778; *see also* Kelly Holman, *Hedge Funds Get Serious About PE: Goodman Deal Marks Evolution of Hedge Funds as Lending Participants in Major Buyouts*, INVESTMENT DEALERS DIG., Nov. 5, 2007, at 3, *available at* 2007 WLNR 22756302 (discussing the abrupt halt of the credit market and the emergence of hedge funds as private lenders).

[89]Moore, *supra* note 19, at C1.

SOUTHWESTERN BELL TELEPHONE, L.P. V. CITY OF HOUSTON: HAS THE FIFTH CIRCUIT BARRED THE USE OF A § 1983 CLAIM TO ENFORCE SECTION 253 OF THE TELECOMMUNICATIONS ACT OF 1996?

ABSTRACT

This comment examines the recent line of federal circuit court of appeals cases that unanimously bar telecommunications companies from enforcing section 253 of the Telecommunications Act of 1996 (the Act) through suits brought under 42 U.S.C. § 1983. It begins by analyzing the cases preceding these holdings that seemed to clear the way for § 1983 suits in this context. It continues by explaining how a controversial United States Supreme Court decision, Gonzaga University v. Doe, *steered courts away from finding a private right of action for telecommunications service providers in the Act. The comment goes on to describe how the Fifth Circuit's decision in* Southwestern Bell Telephone, L.P. v. City of Houston *has failed to systematically preclude § 1983 claims in this context and how an undecided circuit could be convinced to allow them. Finally, it concludes by arguing that public policy should prevent telecommunications providers from bringing § 1983 claims against state governments and recommends that Congress amend the Act accordingly.*

I. INTRODUCTION

Congress passed the Telecommunications Act of 1996[1] (the Act) to deregulate the telecommunications industry and to foster competition among the numerous telecommunications service providers.[2] When the Act took effect, telecommunications providers and federal courts struggled to interpret its meaning.[3] One point of contention that quickly emerged between the states and the telecommunications providers was whether section 253 of the Act created a private right of action for the telecommunications providers

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[1]Pub. L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C.).

[2]The preamble to the Act states the intent of the legislation: "To promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies." *Id.*

[3]*See* Richard E. Wiley, *"A New Telecom Act"—Remarks*, 31 S. ILL. U. L.J. 17, 20-21 (2006) (explaining that the sheer size and complexity of the Act spawned a great deal of litigation over its meaning).

against state and local governments in federal court.[4] Before the Sixth and Eleventh Circuits, the telecommunications providers argued that section 253 gave them a legal remedy to discriminatory right-of-way practices by state and local governments.[5] The Sixth and Eleventh Circuits agreed with the telecommunications providers and found a private right of action within section 253.[6]

These circuits were very close, arguably, to finding that section 253 also gave the telecommunications providers a substantive personal right that was enforceable against the states by suits brought under 42 U.S.C. § 1983.[7] The Supreme Court's holding in *Gonzaga University v. Doe*,[8] however, casts a negative light on § 1983 claims brought under federal statutes.[9] The Second, Ninth, and Tenth Circuits have followed the lead of *Gonzaga* and found that there are no federal rights granted to telecommunications providers under section 253.[10] Each circuit, however, offered a slightly different interpretation of *Gonzaga* as it applied the holding in this context.

When the Fifth Circuit decided *Southwestern Bell Telephone, L.P. v. City of Houston*,[11] it was the fourth consecutive circuit to hold that § 1983 claims were impermissible under section 253 of the Act.[12] The Fifth Circuit's reading of *Gonzaga*, however, has opened the door to a different interpretation of the holdings of the Sixth and Eleventh Circuits, which may lend credence to permitting § 1983 claims in those circuits.[13]

This comment disagrees with the Fifth Circuit's implication that § 1983 claims have been completely precluded under section 253 of the Act by *Gonzaga*. Several viable arguments exist that could convince an

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[4]*See, e.g.*, BellSouth Telecomm., Inc. v. Town of Palm Beach, 252 F.3d 1169 (11th Cir. 2001); TCG Detroit v. City of Dearborn, 206 F.3d 618, 623 (6th Cir. 2000).

[5]*BellSouth*, 252 F.3d at 1191-92; *TCG Detroit*, 206 F.3d at 623.

[6]*BellSouth*, 252 F.3d at 1192; *TCG Detroit*, 206 F.3d at 624.

[7]*See* 42 U.S.C. § 1983 (2005). Section 1983 states, in pertinent part:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress . . . .

Id.

[8]536 U.S. 273 (2002).

[9]*Id.* at 282.

[10]NextG Networks of NY, Inc. v. City of N.Y., 513 F.3d 49, 53 (2d Cir. 2008); Sprint Telephony PCS, L.P. v. County of San Diego, 490 F.3d 700, 717 (9th Cir. 2007); Qwest Corp. v. City of Santa Fe, N.M., 380 F.3d 1258, 1265 (10th Cir. 2004).

[11]529 F.3d 257 (5th Cir. 2008).

[12]*Id.* at 260-62.

[13]*See id.*