

December 2, 2011

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Client Alert

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DELAWARE COURT APPLIES STEP TRANSACTION DOCTRINE TO “ENSURE THE FULFILLMENT OF PARTIES’ EXPECTATIONS” IN MERGER AGREEMENT

Refuses to allow “technical formalities” of transaction structure to “affect how the law views the substance of what truly occurred”

In *Coughlan v. NXP b.v.*,¹ the Delaware Court of Chancery recently applied the step transaction doctrine in determining that a series of actions related to the formation of a joint venture “were part and parcel of the same transaction,” thereby triggering provisions of a merger agreement requiring the acceleration of certain post-closing contingent payments.² However, because the joint venture assumed performance obligations of one of the parties related to the contingent payments – although not the specific obligation to make the contingent payments if earned – the Court ruled that acceleration of the contingent payments was not required under the terms of the merger agreement.

Background

In December 2007, GloNav, Inc., “a developer of GPS-related semiconductors,” entered into a merger agreement with NXP b.v., “a semiconductor company based in the Netherlands.” Upon consummation of the merger on January 23, 2008, GloNav stockholders received cash in exchange for their GloNav shares and GloNav survived as a wholly-owned subsidiary of NXP. The merger agreement designated Elaine Coughlan as the “Stockholder’s Representative” for the former GloNav stockholders.

In addition to the cash payments to be made at closing, the merger agreement provided for contingent payments to the former GloNav stockholders if GloNav

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¹ 2011 WL 5299491 (Del. Ch. November 4, 2011).

² For a discussion of a recent Delaware Supreme Court decision (applying New York law) refusing to apply the step transaction doctrine to the interpretation of an indenture’s successor obligation provision, see our Client Alert entitled “Delaware Supreme Court Provides Guidance on Interpretation of ‘Boilerplate’ Indenture Provisions”, dated November 2, 2011.

achieved “certain revenue and product development targets” post-closing (collectively, “Contingent Payments”). In furtherance of the Contingent Payments obligations, the merger agreement obligated NXP “to develop an operating plan for the GloNav business that was ‘aligned with the achievement of the [targets]’ and to provide GloNav with the tools ...and other support needed to achieve the targets.” Additionally, the merger agreement provided that, in the event of certain “change of control” transactions involving a sale of (i) “a majority of the outstanding stock of or other equity interests in [GloNav]”, (ii) “all or substantially all the assets of [GloNav]” or (iii) “a portion of the assets of NXP in which all or substantially all of such assets consist of all or substantially all of the assets of [GloNav],” any remaining Contingent Payments would be accelerated unless the acquirer agreed to “assume all of NXP’s remaining obligations under” the section of the merger agreement governing the Contingent Payments.

Then, in April 2008, NXP entered into a joint venture with STMicroelectronics, “a French semiconductor company,” whose purpose was to “combine[] the companies’ wireless businesses.” Pursuant to the terms of the JV agreement, NXP transferred various assets – including the assets constituting the GloNav business – to the joint venture in a two-step transaction. In the first step, NXP contributed its non-Dutch wireless businesses, including the GloNav assets, to a newly-formed subsidiary. In the second step, NXP transferred all of the shares of this subsidiary to the joint venture in return for a 20% stake in the joint venture and a cash amount, which was contributed by ST along with certain of its wireless assets. ST received an 80% stake in the joint venture in consideration of its contributions. Although NXP retained its obligation to make the Contingent Payments if they were earned, the JV agreement assigned NXP’s related performance obligations under the merger agreement to the joint venture.

Following formation of the joint venture, NXP continued to make Contingent Payments as the GloNav business achieved the relevant targets. However, as a result of the 2008 financial crisis, the milestones for the final \$5 million in Contingent Payments were not met. In an effort nevertheless to obtain the remaining Contingent Payments, Stockholder Representative Coughlan filed suit in the Court of Chancery in October 2009, claiming that the remaining Contingent Payments had been accelerated by virtue of (i) the transfer by NXP of GloNav’s assets to the joint venture and (ii) the failure of the joint venture to assume NXP’s obligations to actually make the Contingent Payments under the merger agreement.

In response to Coughlan’s summary judgment motion, NXP argued that none of the triggering events for acceleration had occurred because (i) the *first step*, which involved NXP’s transfer of GloNav assets to a wholly-owned subsidiary, was an “exempt” transfer for purposes of the merger agreement, and (ii) the *second step*, involving the transfer of shares of the subsidiary to the joint venture, was not an acceleration triggering event under the merger agreement. Further, NXP argued that the joint venture’s assumption of NXP’s performance obligations under the merger agreement was sufficient to negate acceleration even if a triggering event was deemed to have occurred. On this basis, NXP cross-moved for summary judgment.

The Court’s Analysis

The Court granted summary judgment to NXP, concluding that although a change of control of the GloNav business had occurred by virtue of the formation of the joint venture, acceleration of the remaining Contingent Payments was not triggered because the joint venture had assumed NXP’s performance obligations with respect to the Contingent Payments for purposes of the merger agreement.

Application of the Step Transaction Doctrine

To determine whether, as Coughlan claimed, the two seemingly separate steps used to effectuate NXP's transfer of GloNav assets to the joint venture constituted a change of control of GloNav that triggered acceleration of the Contingent Payments, the Court invoked the step transaction doctrine. This was required because neither step, taken alone, literally was a transaction that could trigger acceleration. According to the Court, the "[step transaction] doctrine treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction if all of the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan."³

Next, the Court delineated the "three different analyses in applying the step transaction doctrine": (1) the "*end result test*," under which a series of transactions is aggregated "if the 'separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result,'" (2) the "*interdependence test*," under which a series of transactions is aggregated "if the steps are not interdependently significant and '[have] meaning only as part of the larger transaction,'" and (3) the "*binding commitment test*," under which a series of transactions is aggregated "'if, at the time the first step is entered into, there was a binding commitment to undertake the later steps.'"

The Court determined that all three tests were satisfied and, therefore, under the step transaction doctrine, "although neither of the two transactions alone were Triggering Events," "the two transactions that resulted in the Joint Venture's ownership of GloNav's assets were part and parcel of the same transaction." While acknowledging, as NXP argued, that "a court should refrain from applying the step transaction doctrine to interpret a contract if doing so would contravene the parties' intent," the Court observed that "there is nothing in the Merger Agreement's drafting history that suggests that the acceleration was not meant to occur upon a series of interdependent transactions that, when analyzed substantively rather than hyper-technically, clearly fits within the transactions enumerated in" the merger agreement provisions triggering acceleration. In the Court's view, "[t]o allow NXP to circumvent the protections of ... [the acceleration provisions] simply by using a subsidiary to transfer the assets of GloNav to the Joint Venture would render those protections meaningless. Further, '[i]t is well settled in Delaware that our courts 'will not read a contract to render a provision meaningless or illusory.'"⁴

NXP also argued that the step transaction doctrine had its origins in, and should not be applied outside the context of, the tax treatment of asset transfers and fraudulent conveyances. The Court rejected this argument as well, noting that Delaware courts previously had "extended the doctrine to partnership agreements, warrant agreements, and recapitalization transactions," all on the basis that "transactional formalities will not blind the court to what truly occurred. Indeed, 'it is the very nature of equity to look beyond form to the substance of an arrangement.'"⁵ And just in case an appellate review might result in a finding that "the step transaction doctrine did not apply in this case," the Court went on to rule that it "would still consider the two transactions together as a matter of equity" because "equity regards substance rather than form."⁶

³ Citing *Noddings Inv. Group, Inc. v. Capstar Commc'ns, Inc.*, 1999 WL 182568 (Del. Ch. Mar. 24, 1999).

⁴ Citing *Osborn v. Kemp*, 991 A.2d 1153 (Del. 2010).

⁵ Citing *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007).

⁶ Citing *In re Cencom Cable Income Partners, L.P.*, 2000 WL 130629 (Del. Ch. Jan. 27, 2000).

Assumption of Contingent Payment Obligations

Next, the Court turned to the question whether the joint venture's assumption of NXP's performance obligations in respect of the Contingent Payments, but not its payment obligations, prevented triggering of the acceleration provisions. Rejecting Coughlan's claim that the joint venture had assumed neither NXP's performance nor payment obligations, the Court concluded that various provisions of the JV agreement, "read as a whole ... plainly indicate that the ST Joint Venture assumed NXP's Performance Obligations and that NXP retained its Payment Obligations." Because "the record is clear that the Joint Venture provided GloNav with the resources it needed to continue to meet the product development milestones" and that NXP "continued to make Contingent Payments as the relevant milestones were reached," the Court concluded that the former GloNav stockholders "got exactly what they bargained for: contingent payments when the relevant milestones were reached."

Thus, even though "the word 'all' ... could be read to require ... that the ST Joint Venture assume both the Performance and Payment Obligations of NXP," the Court viewed its "role" as requiring it "to derive meaning from the contractual language chosen by the parties *as a whole*, through which the parties set forth their respective obligations." As a result, the Court did "not find it relevant which entity ... was required by the terms of the JV Agreement to be the source of the funds that NXP was required to deliver ... under the terms of the Merger Agreement." Either way, "the Contingent Payments continued to be paid ... following a change in control of GloNav – precisely as contemplated in the Merger Agreement."

Conclusion

The *Coughlan* Court's application of the step transaction doctrine to negate the desired impact of formally separating an asset transfer into two separate steps demonstrates that, for purposes of Delaware contract interpretation, "transactional creativity" employed by clever dealmakers and lawyers in structuring a transaction "should not affect how the law views the substance of what truly occurred." Though the step transaction doctrine was historically used primarily in tax and bankruptcy courts, it is important for contracting parties to be aware that Delaware courts will utilize the doctrine in interpreting general business contracts. No matter how heavily negotiated a contract or how sophisticated the parties, the *Coughlan* ruling teaches that the Court of Chancery will look beyond "technical formalities" in order "to ensure the fulfillment of parties' expectations"

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