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Corporate Governance Group Client Alert

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Federal Court Refuses to Dismiss Claims Brought by Target Company Shareholders Against Lender who Failed to Provide Merger Financing

As those who follow the financial press are well aware, the recent crisis in the credit markets – and the resulting inability of private equity buyers to obtain financing to complete pending transactions – has created havoc with a number of leveraged buyouts. Some of these transactions have died, others have been renegotiated and still others have found their way into the courts. In one recent case, a lender who was unable, or perhaps unwilling, to honor a financing commitment found itself exposed to potential liability, not to the recipient of its commitment letter – the private equity buyer – or to the target company, but rather to a more remote group, shareholders of the target company. In *Lasker v. UBS Securities LLC*, the U.S. District Court for the Eastern District of New York, applying Tennessee law, denied UBS' motion to dismiss a purported class action lawsuit brought by shareholders of Genesco, Inc., alleging tortious interference with a business relationship on the part of UBS for failing to finance The Finish Line's buyout of Genesco.¹ This decision is all the more surprising because the merger agreement between Finish Line and Genesco contained an express disclaimer of third-party beneficiaries and a Tennessee Chancery Court actually had sided with UBS in a parallel lawsuit.

In June 2007, Finish Line entered into a merger agreement with Genesco and executed a commitment letter with UBS to provide debt financing for the merger. After the necessary regulatory approvals for the merger were obtained, UBS sent a letter to Finish Line expressing concern about Genesco's "apparent deteriorating financial position". UBS also reserved its rights under the commitment letter to revoke its commitment to complete the financing in the event Genesco experienced a "Material Adverse Effect". Even after Genesco provided UBS with updates of its financial results that were consistent with industry performance (including Finish Line's), UBS continued to express concern to Finish Line that Genesco was experiencing a material adverse effect.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided herein.

In addition, if you would like copies of our other Client Alerts or the *Lasker* decision discussed herein, please contact any of the attorneys listed. You can also obtain this and our other Client Alerts by visiting our website at <http://www.milbank.com> and choosing the "Client Alerts & Newsletters" link under "Newsroom/Events".

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¹ 2008 WL 1968737 (E.D.N.Y. 2008).

On September 17, 2007, Genesco shareholders voted to approve the merger, thereby triggering an obligation on Finish Line's part to close the merger on or before September 19, 2007. On September 18, 2007, UBS indicated that it would stop any further work towards closing the transaction "pending the results of its analyses of Genesco's financial condition and performance", and Finish Line issued a press release the next day that it "would 'consider its options' under the Merger Agreement." Genesco responded by filing suit against UBS in the Tennessee Chancery Court. That Court rejected UBS' argument that Genesco had suffered a material adverse effect because the merger agreement expressly eliminated general economic conditions as a basis for claiming a material adverse effect, and ordered specific performance of the merger.

In addition, Genesco's shareholders responded to the threat of failed financing by filing their tortious interference suits against UBS in the Tennessee Chancery Court and the U.S. District Court for the Eastern District of New York. The Tennessee Chancery Court ruled that Genesco's shareholders did not have standing based on the merger agreement's express disclaimer of third-party beneficiaries. In contrast, the U.S. District Court (applying Tennessee law) refused to dismiss the Genesco shareholders' purported class action claim, indicating that, at least at this procedural stage, it was "plausible" that the plaintiffs would be able to satisfy the key elements necessary to state a claim for tortious interference with a business relationship, including (i) an existing business relationship with specific third parties or a prospective relationship with an identifiable class of third persons and (ii) the defendant's *improper motive* or *improper means*.

The Court characterized the plaintiff's theory of an existing business relationship between UBS and Genesco's shareholders based on their "economic expectancy in receiving the \$54.50 per share once Genesco had satisfied the conditions precedent to closing" as being "somewhat novel". Nevertheless, the Court ruled that "Tennessee would recognize a business relationship on the facts alleged, particularly because Genesco had satisfied the pre conditions to closing." Accordingly, this key element of the test for proving tortious interference was satisfied.

With respect to the other key element, the Court found that while UBS had not acted with an *improper motive*, it may have used *improper means* by counterclaiming – as it turned out, unsuccessfully – in the original lawsuit brought by Genesco for specific performance that Genesco had engaged in fraud during the merger negotiations. The Court stated that "improper means" could include "unethical conduct, such as sharp dealing, overreaching, or unfair competition." Further, the Court, "[d]rawing all inferences in favor of plaintiff" in connection with UBS' motion to dismiss, determined that plaintiff's claims were "sufficient to allege that [UBS] engaged in unfounded litigation" and, therefore, that UBS had acted with the requisite "improper means". Accordingly, the Court denied UBS' motion to dismiss.

The *Lasker* decision should alert financial institutions – particularly in the current environment of troubled and failed transactions – to potential liability to third-party shareholders, even when a merger agreement disclaims third-party liability. Unhappy shareholders (and clever plaintiffs' counsel) are likely to seek to take advantage of this precedent as a basis for seeking compensation from deep-pocketed financial advisors and lenders who are not traditionally viewed as having liability to shareholders. At the very least, the *Lasker* decision could cause financial advisors and lending institutions, and their legal counsel, to consider including provisions in commitment letters, loan agreements and merger agreements to clarify that target company shareholders specifically are not intended as beneficiaries of the financing arrangements entered into in support of a leveraged buyout.

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