



Corporate Governance Group Client Alert

BEIJING FRANKFURT HONG KONG LONDON LOS ANGELES MUNICH NEW YORK SINGAPORE TOKYO WASHINGTON, DC

FEDERAL COURT FINDS THAT PRIVATE EQUITY FIRM DID NOT BREACH “MAKE WHOLE” PROVISION OF STOCK PURCHASE AGREEMENT THROUGH TIMING OF SUBSEQUENT SALE

Private sellers of corporate assets often seek to negotiate a post-closing “make whole” payment in the event that the purchaser “flips” the asset at a profit relatively soon after the original sale is completed. Such a provision is usually motivated not so much by the seller’s greed as it is by its desire to avoid the embarrassment of discovering that it undervalued the asset and could have held out for a higher price. Hence the appellation “schmuck insurance”.

In *Orfalea v. Clayton*,¹ the U.S. District Court for the Southern District of New York recently granted summary judgment to the prominent LBO firm, Clayton, Dubilier & Rice (“CD&R”), in an action alleging that CD&R had breached the “make whole” provision of a stock purchase agreement documenting its acquisition of Kinko’s. While disagreeing with CD&R’s narrow construction of the “make whole” provision, the Court nevertheless found that CD&R was not required to pay additional compensation to the plaintiff when it sold its Kinko’s shares at a profit more than nine months following the closing of the original acquisition transaction.

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¹ 07 Civ. 2256 (S.D.N.Y. September 30, 2009).

Background

On December 20, 2002, CD&R completed its acquisition of Kinko's from Paul Orfalea at a price of \$15 per share, representing an aggregate price of just over \$95 million. Section 7(a) of the stock purchase agreement between CD&R and Orfalea provided that if CD&R sold, or entered into an agreement for the sale of, its Kinko's shares within nine months following the closing date at an average purchase price greater than \$15 per share, CD&R would be required to pay additional compensation to Orfalea in the amount of the excess. This nine-month "make whole" provision was scheduled to expire on September 20, 2003.

CD&R first began exploring a possible sale of Kinko's as early as the summer of 2003 and, in that connection, put together a list of multiple potential buyers, which included FedEx Corporation. CD&R began discussions with Pitney Bowes regarding a potential sale in August, but these discussions broke down in November over the inability to agree on price. Shortly thereafter, FedEx contacted CD&R about a possible acquisition. These discussions culminated in the signing on December 29, 2003 of an agreement for the sale of Kinko's to FedEx at a purchase price of \$37 per share. The acquisition closed on February 12, 2004.

Orfalea filed suit on March 16, 2007, alleging that the sale to FedEx triggered his entitlement to additional compensation under his stock purchase agreement with CD&R, even though that sale took place more than nine months following the original closing. Orfalea focused specifically on the last sentence of the "make whole" provision, which provided that CD&R would "act in good faith to give effect to the spirit of the protections" granted to Orfalea and would not "initiate any transaction designed to circumvent" those protections. Orfalea argued that the sale to FedEx was designed to do just that, by delaying the consummation of the transaction until the expiration of the nine-month period following the closing of his original sale to CD&R.

The Court's Analysis

As an initial matter, the Court rejected CD&R's argument that the "make whole" provision required a payment to Orfalea *only* in the event of a sale or agreement to sell occurring within the nine-month period following closing. According to the Court, this interpretation would render "superfluous and meaningless" the final sentence of the provision requiring CD&R to "act in good faith" and to refrain from designing a transaction to "circumvent" the protections negotiated by Orfalea. Instead, the Court agreed with Orfalea's position that "[t]he clear intent of this provision is to prevent CD&R from initiating a transaction that would require a payment if it were consummated within the nine-month period, but then circumventing the payment obligation by delaying consummation until after the nine-month period."

However, Orfalea in effect won the battle but lost the war when the Court determined that CD&R, even under this more expansive reading of the "make whole" provision, had not structured the sale to FedEx in such a way as to avoid paying additional compensation to Orfalea. Specifically, the Court found that CD&R's internal discussions of the potential sale of Kinko's did not constitute the "initiation of 'a transaction designed to circumvent' the agreement." Further, when the sale of Kinko's was first explored in May 2003, FedEx was only one of multiple potential buyers considered, and the Court found that Orfalea had offered no evidence that CD&R had initiated a transaction with FedEx prior to the September 20, 2003 expiration of the "make whole" provision. In this connection, the Court observed that adopting Orfalea's position would require it to stretch "beyond the clear meaning" of the good faith requirement of the "make whole" provision and thereby place "an undue burden" on CD&R in connection with the disposition of its investment in Kinko's.

Conclusion

It is significant – but should not be surprising – to dealmakers and their advisors that the *Orfalea* Court gave effect to the good faith, non-circumvention provision of the “make whole” covenant negotiated with CD&R. In fact, because, as the Court noted, New York law provides that “every contract has an implied covenant of good faith and fair dealing,” the Court might have invoked this implied covenant to limit CD&R’s ability to delay consummation of the Kinko’s sale in order to circumvent the “make whole” provision even in the absence of the specific good faith requirement contained in the stock purchase agreement. At the same time, however, it should be of comfort to those same dealmakers and advisors that the Court refused to adopt an expansive interpretation that would have required a “make whole” payment under circumstances likely not contemplated by the parties at the time of the original Kinko’s transaction.

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 below.

Beijing

Units 05-06, 15th Floor, Tower 2
China Central Place, 79 Jianguo Road, Chaoyang District
Beijing 100025, China

Anthony Root +86-10-5969-2777 aroot@milbank.com
Edward Sun +86-10-5969-2772 esun@milbank.com

Frankfurt

Taunusanlage 15
60325 Frankfurt am Main, Germany

Norbert Rieger +49-69-71914-3453 nrieger@milbank.com

Hong Kong

3007 Alexandra House, 18 Chater Road
Central, Hong Kong

Anthony Root +852-2971-4842 aroot@milbank.com
Joshua Zimmerman +852-2971-4811 jzimmerman@milbank.com

London

10 Gresham Street
London EC2V 7JD, England

Stuart Harray +44-20-7615-3083 sharray@milbank.com
Thomas Siebens +44-20-7615-3034 tsiebens@milbank.com

Los Angeles

601 South Figueroa Street
Los Angeles, CA 90017

Ken Baronsky +1-213-892-4333 kbaronsky@milbank.com
Neil Wertlieb +1-213-892-4410 nwertlieb@milbank.com

Munich

Maximilianstrasse 15 (Maximilianhoefer)
80539 Munich, Germany

Peter Nussbaum +49-89-25559-3636 pnussbaum@milbank.com

New York

One Chase Manhattan Plaza
New York, NY 10005

Scott Edelman +1-212-530-5149 sedelman@milbank.com
Roland Hlawaty +1-212-530-5735 rhlawaty@milbank.com
Thomas Janson +1-212-530-5921 tjanson@milbank.com
Robert Reder +1-212-530-5680 rreder@milbank.com
Alan Stone +1-212-530-5285 astone@milbank.com
Douglas Tanner +1-212-530-5505 dtanner@milbank.com

Singapore

30 Raffles Place, #14-00 Chevron House
Singapore 048622

David Zemans +65-6428-2555 dzemans@milbank.com
Naomi Ishikawa +65-6428-2525 nishikawa@milbank.com

Tokyo

21F Midtown Tower, 9-7-1 Akasaka, Minato-ku
Tokyo 107-6221 Japan

Darrel Holstein +813-5410-2841 dholstein@milbank.com
Bradley Edmister +813-5410-2843 edmister@milbank.com

Washington, DC

International Square Building, 1850 K Street
Washington, DC 20006

Glenn Gerstell +202-835-7585 gerstell@milbank.com