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IN THE COURTS

Delaware Court of Chancery Applies Step Transaction Doctrine to Contract Interpretation.

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The Delaware Court of Chancery issued its memorandum opinion in *Coughlan v. NXP B.V.*¹ on November 4, 2011, confirming that the step transaction doctrine—an interpretive regime originally developed in the tax context—has a place in the Court’s toolbox as means of evaluating whether related but superficially separate transactions should be regarded as one unified transaction for purposes of contract interpretation. The case called on the Court to interpret two provisions of a merger agreement in an action brought by the appointed representative of an acquired corporation’s former stockholders,

who alleged that certain obligations to former stockholders had been accelerated by transfer of the acquired business into a joint venture. The Court concluded, by application of the step transaction doctrine, that a triggering event occurred, thereby potentially requiring acceleration. The Court also concluded, however, that acceleration was precluded because separate provisions of the merger agreement were satisfied by transfer of certain duties to the joint venture. The Court therefore granted defendant’s motion for summary judgment.

The GloNav Merger And The Contingent Payments

The parties’ dispute arose out of the January 2008 all-cash merger of GloNav, Inc. (GloNav), a developer of semiconductors for the GPS industry, with and into a wholly-owned subsidiary of NXP b.v. (NXP), a Dutch semiconductor company (Merger), pursuant to a merger agreement executed in December of the previous year (Merger Agreement).² Although the former stockholders of GloNav (Former Stockholders) were wholly divested of their shares following the Merger, they retained certain contractual rights under the Merger Agreement. Specifically, Section 2.4 of the Merger Agreement obligated NXP to deliver certain scheduled payments to the Former Stockholders, contingent on achievement of specified revenue and product development targets during the years 2008 and 2009 (Contingent Payments).³

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Under the terms of the Merger Agreement, such payments could total a maximum of \$25 million.⁴ Section 2.4 provided certain protections to ensure the Former Stockholders received the Contingent Payments, including requiring NXP to develop an operating plan for the business “that was ‘aligned with the achievement of the Product Development Target’” and to “provide GloNav with the tools, libraries, intellectual property, and other support needed to achieve the targets.”⁵

The Merger Agreement also included two provisions that would, in the event of certain specified change-in-control transactions and subject to certain exceptions, either accelerate payment of the Contingent Payments or transfer the obligations associated with such payments to an acquirer.⁶ The first provision provided that the Former Stockholders would be entitled to receive all Contingent Payments then remaining available in the event of a sale or transfer of “either (x) a majority of the outstanding capital stock of or other equity interests in [GloNav], (y) all or substantially all of the assets of [GloNav], or (z) 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]” (Triggering Event).⁷ The second provision provided an exception to the first whereby, in a transfer of GloNav assets as part of a larger transaction involving NXP, the acquirer could elect either to pay the maximum amount of Contingent Payments then potentially available or assume NXP’s obligations with respect to the Contingent Payments.⁸

The ST Joint Venture

Simultaneously with entering into the Merger Agreement, NXP undertook negotiations to form a joint venture with STMicroelectronics (ST), a French semiconductor company. NXP and ST executed an agreement (JV Agreement) in April 2008, under the terms of which the two companies formed a new organization, ST-NXP

Wireless (ST Joint Venture) to contain all of each companies’ wireless businesses, including GloNav.⁹ The parties completed all transactions creating the ST Joint Venture in July 2008, after which ST owned 80 percent of the ST Joint Venture and NXP owned the remaining 20 percent.

NXP’s role in creation of the ST Joint Venture was effectuated by two sequential transactions. First, NXP created a pair of wholly-owned subsidiaries, into which it transferred all of its wireless businesses, including GloNav. Then, at closing of the Merger, NXP transferred the shares of the two subsidiaries to the ST Joint Venture in exchange for its 20 percent stake and \$1.52 billion in cash. The JV Agreement specified which duties connected to transferred assets would be assumed by the ST Joint Venture, and which would be retained by NXP. In particular, NXP retained its obligation to make the Contingent Payments, but assigned all “Performance Obligations” to the ST Joint Venture itself.¹⁰ Thus, NXP would continue to deliver the Contingent Payments as they came due, and the ST Joint Venture would assure that GloNav had the resources it needed to meet the required milestones.¹¹

NXP’s participation in the ST Joint Venture would be short-lived. In February 2009, ST purchased all of NXP’s interest pursuant to certain preexisting call options, which the parties agreed to accelerate subsequent to ST’s announcement that it had agreed to form a new joint venture with Ericsson.¹² It was undisputed, however, that NXP continued to make the Contingent Payments as they came due.

NXP Makes the Contingent Payments but the Stockholders’ Representative Demands Acceleration

The first of the Contingent Payments, in the amount of \$3 million, came due prior to the announcement of the ST Joint Venture and was paid by NXP as required by the Merger Agreement. Following announcement of the ST Joint

Venture, Elaine Coughlan, the Former Stockholders' appointed representative, contacted NXP by letter. Coughlan requested that the remaining Contingent Payments be accelerated as a consequence of the ST Joint Venture, or that NXP "advise [her] on how the new owners intend[ed] to ensure the continuity of [the] agreement through this M&A Process."¹³ NXP replied that the ST Joint Venture would "assume all of NXP's remaining obligations," and that acceleration would therefore not be triggered by the terms of the Merger Agreement.¹⁴ In the ensuing months, Coughlan sent additional similar letters demanding acceleration.¹⁵ In all of its communications with Coughlan, NXP took the position that no Triggering Event had occurred and acceleration therefore was not required.

By early September 2009, only \$5 million in Contingent Payments remained, the rest having been paid or having failed to accrue due to poor business performance.¹⁶ In October of that year, Coughlan wrote NXP, again asserting that NXP's obligations had not been assumed as required by the Merger Agreement, and this time arguing that NXP's continued fulfillment of the Contingent Payments was "at odds with the assumption by the ST Joint Venture."¹⁷ NXP again communicated to Coughlan its position that the Contingent Payments had not been accelerated, and claimed that nothing in the Merger Agreement precluded NXP from continuing to make the Contingent Payments despite the ST Joint Venture having assumed its obligations under the Merger Agreement.¹⁸

Plaintiff thereafter filed suit in the Delaware Court of Chancery, claiming that the ST Joint Venture had failed to assume the obligations required by the Merger Agreement in a transfer of the GloNav business, thereby giving rise to a Triggering Event and accelerating the remaining \$5 million in Contingent Payments. NXP argued in response that the Merger Agreement obligated it only to transfer certain obligations related to supporting GloNav's operations, which

obligations the ST Joint Venture had assumed under the terms of the JV Agreement.¹⁹ Both parties moved for summary judgment.

The Court of Chancery's Decision

The Court approached its task, as in any exercise of contract interpretation, with the objective of effectuating the contracting parties' intent. It was uncontested that each of NXP's two transactions on its own would not give rise to a Triggering Event. It was also clear, however, that a Triggering Event would arise under the Merger Agreement if the two transactions were treated as a unified transfer of GloNav's assets into the ST Joint Venture. Coughlan therefore argued that the Court should treat the two transactions as one for purposes of interpreting a Triggering Event. The plain language of the Merger Agreement, however, failed to specify the circumstances, if any, under which separate transactions could be so treated.

Despite the lack of textual guidance, Coughlan argued, and the Court of Chancery agreed, that NXP should not be permitted to avoid its contractual obligations by means of transactional artifice. Coughlan persuaded the Court that NXP's two-part transfer of GloNav's assets should be treated as a unified event under the step transaction doctrine, an interpretive tool that arose out of tax law as a means of deciding whether superficially separate transactions should be treated as a unified event, thereby "dictat[ing] consideration of the series as one transaction for the purposes of a given legal analysis."²⁰ The doctrine treats the steps in a series of separate but related transactions as one transaction if all of the steps are linked under one or more of three tests. First, the "end result test" deems a series of transactions as a step transaction "if the 'separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result.'"²¹ Second, the "interdependence test" analyzes whether the steps are independently significant or whether they only

have meaning as part of a greater transaction.²² Finally, the “binding commitment test” deems a series of transactions to be one if, when the first step was entered into, there was a binding commitment to undertake the subsequent steps.²³

Just a few months before the *Coughlan* decision, adding to a thin but potent line of Delaware decisions considering the application of the step transaction doctrine, Vice Chancellor Laster applied the doctrine in another case to decide whether, under New York law, several spin-off transactions undertaken over the course of nearly a decade divested a corporation of “all or substantially all” of its assets such that a bond indenture’s successor obligor covenant would be triggered.²⁴ Although the Vice Chancellor in *Liberty* did not rely exclusively on the step transaction doctrine in reaching his decision that the covenant had not been triggered, he did identify it as “an appropriate doctrinal tool” to bring the facts into “sharper focus” for purposes of interpreting the covenant.²⁵ On appeal, the defendant in *Liberty* argued that the Court of Chancery had erred by invoking the step transaction doctrine to interpret the bond indenture at issue.²⁶ The Delaware Supreme Court concluded, however, that it need not reach the issue of whether the Court of Chancery properly invoked the doctrine. Rather, the Supreme Court concluded that the Vice Chancellor’s separate examination of precedent unrelated to the doctrine correctly led to his decision not to aggregate the transactions at issue.²⁷ The Supreme Court’s decision therefore left open the question of whether the step transaction doctrine may be applied to consider whether to treat multiple transactions as one where the parties have failed to provide a textual basis for doing so in their contract.

Similar to the defendant in *Liberty*, NXP argued that the step transaction doctrine was inapplicable outside of the tax and fraudulent conveyance contexts, and that applying the doctrine to interpretation of its contractual relationship with the Former Stockholders would “violate the intent of the parties.”²⁸ As to the former argument,

the Court noted multiple arenas in which it had applied the doctrine, including “partnership agreements, warrant agreements, and recapitalization transactions,” each of which exemplified the “governing principle” that “transactional formalities will not blind the court to what truly occurred.”²⁹ It therefore found no basis to avoid application of the doctrine in this case.

While the Court agreed with NXP that it should “refrain from applying the step transaction doctrine to interpret a contract if doing so would contravene the parties’ intent,” it concluded that the doctrine provided an appropriate analytical tool in the present case.³⁰ In cases where the Court is asked to apply a doctrinal tool like the step transaction doctrine to interpret the intent of contracting parties, the Court concluded, “the controlling principal . . . is the effectuation of ‘the parties’ intentions as expressed in, or reasonably inferred from, their agreement.’”³¹

The step transaction doctrine, the Court found, provided the appropriate analytical tool to identify the parties’ intent here because “nothing in the Merger Agreement’s drafting history . . . suggest[ed] 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 change-of-control provision].”³² Instead, the Court found it “clear” that, examining the Merger Agreement as a whole, the parties’ intent had been “to ensure that the [Former Stockholders] would continue to receive their bargained-for Contingent Payments in the event that NXP sold GloNav.”³³ To allow NXP to avoid its obligations simply by splitting a transaction into two pieces, the Court found, “would render those protections meaningless,” and lead to the impermissible result of rendering the Former Stockholders’ bargained-for protections illusory.³⁴

The Court therefore concluded that application of the step transaction doctrine was appropriate, and found each of its three tests easily satisfied

by NXP's actions in creating the ST Joint Venture. Those actions satisfied the end result test because the two transactions NXP undertook to create the ST Joint Venture "were provided for under a single agreement the purpose of which was to achieve the ultimate result of the Joint Venture's ownership of GloNav."³⁵ The interdependence test was satisfied because each of the two transactions was "so interdependent on [the other] that it would have been fruitless in isolation."³⁶ Finally, the two transactions satisfied the binding commitment test because "the JV Agreement obligated NXP to transfer the GloNav business to the ST Joint Venture in two steps."³⁷ The Court therefore found it "clear" that each of the step transaction doctrine's three tests had been satisfied.³⁸ The Court added, however, that NXP's two transactions could also be regarded as one for purposes of identifying a Triggering Event "as a matter of equity," which regards "substance rather than form," in evaluating a transaction.³⁹ The Court made clear, therefore, that a holding that a Triggering Event had occurred would have been the result even without application of the step transaction doctrine.

Despite finding that transfer of the GloNav assets gave rise to a Triggering Event, the Court nevertheless concluded that acceleration was not required. It found, rather, that NXP had satisfied its obligations under the Merger Agreement by transferring to the ST Joint Venture all required duties. Although Coughlan argued that the JV Agreement failed to transfer *any* duties with respect to the contingent payments, the Court found the plain language of the agreement to the contrary. In relevant part, the JV Agreement provided that the ST Joint Venture "shall . . . meet all the Earn-Out Obligations assumed by the relevant Group Company in respect of the Earn-Out Payments."⁴⁰ Coughlan argued that this provision required only that the ST Joint venture would meet whatever duties that it assumed. The Court concluded, however, that such a "hyper-technical" reading would circumvent the plain language of other provisions of the JV Agreement, which

"plainly indicate[d] that the ST Joint Venture assumed NXP's Performance Obligations and that NXP retained its Payment Obligations."⁴¹ Such an arrangement, the Court concluded, satisfied NXP's obligations under the Merger Agreement and precluded acceleration of the remaining Contingent Payments. Moreover, the Court found that both NXP and the ST Joint Venture had satisfied their respective duties. The ST Joint Venture met its Performance Obligations by "provid[ing] GloNav with the resources it needed," and NXP met its Payment Obligations by delivering payments as required by the Merger Agreement.⁴² Finding it unimportant from whose coffers the cash for the Contingent Payments came, and noting in particular that all required payments had been in fact made, the Court granted NXP's motion for summary judgment.⁴³

Conclusion

Vice Chancellor Glasscock's decision in *Coughlan* confirms, particularly when read in conjunction with earlier decisions such as the *Liberty* case discussed above and Vice Chancellor Parsons's 2007 decision in *Twin Bridges Limited Partnership v. Draper*,⁴⁴ that at least some members of the current Court of Chancery consider the step transaction doctrine a potential tool to interpret the conditions under which technically separate but related transactions should be treated as one for purposes of contract interpretation. As noted above, the Delaware Supreme Court did not address the issue in *Liberty* at the appeal stage of that case but appears to have earlier endorsed the application of the step transaction doctrine under certain circumstances in *Gatz v. Ponsoldt*.⁴⁵ Importantly, though the *Gatz* Court did not apply the step transaction doctrine, its decision to analyze a recapitalization as two transactions, and not the single transaction its proponents presented it as, effectively mirrored the considerations of the Court of Chancery in *Coughlan* and other cases cited above, as the *Gatz* Court reasoned that a contrary analysis would "unjustly exalt form over substance."⁴⁶

Given this line of decisions, including the recent *Coughlan* decision, it seems that the step transaction doctrine's role in contract interpretation (and possibly beyond) under Delaware law is, at least for now, well-established. Parties drafting an agreement enforceable in Delaware or under Delaware law therefore would be wise to take care when crafting a provision under which the issue of combining nominally separate asset-transferring transactions might arise. Having rejected the argument that application of the step transaction doctrine under such circumstances would fail to effectuate the parties' intent, Delaware Courts have shown themselves willing to use the doctrine to fill in where a contract wants for specificity.

Notes

1. 2011 WL 5299491 (Del. Ch. Nov. 4, 2011).
2. *Id.* at *1.
3. *Id.* at *1-2.
4. *Id.* at *2.
5. *Id.* at *1.
6. *Id.* at *2.
7. *Id.* (quoting Merger Agreement § 2.4(h)(i)) (text insertions in the original).
8. *Id.* (quoting Merger Agreement § 2.4(h)(ii)).
9. *Id.* at *3.
10. *Id.* at *4.
11. *See id.* at *12.
12. *Id.* at *4.
13. *Id.* (internal quotation marks omitted, text insertions in the original).
14. *Id.*
15. *Id.* at *4-5.
16. *Id.* at *5.
17. *Id.*
18. *Id.* at *6.
19. *Id.*
20. *Id.* at *7, *9.
21. *Id.* at *7 (quoting *Noddings Inv. Group, Inc. v. Capstar Commc'ns, Inc.*, 1999 WL 182568, at *6 (Del. Ch. Mar. 24, 1999)).
22. *Id.* at *8.
23. *Id.* (citing *Noddings*, 1999 WL 182568, at *6).
24. *See Liberty Media Corp. v. Bank of N.Y. Mellon Trust Co.*, 2011 WL 1632333 (Del. Ch. Apr. 29, 2011).
25. *Id.* at *16.
26. *Bank of New York Mellon Trust Co., N.A. v. Liberty Media Corp.*, 29 A.3d 225, 240 (Del. 2011).
27. *Id.* at 244.
28. *Coughlan*, 2011 WL 5299491, at *8.
29. *Id.* at *9 (citing *Twin Bridges Ltd. P'ship v. Draper*, 2007 WL 2744609, at *10 (Del. Ch. Sept. 14, 2007); *Noddings Inv. Group, Inc. v. Capstar Commc'ns, Inc.*, 1999 WL 182568, at *7 (Del. Ch. Mar. 24, 1999); *Gatz v. Ponsoldt*, 925 A.2d 1265, 1281 (Del. 2007)).
30. *Id.* at *8.
31. *Id.* at *9 (quoting *Twin Bridges*, 2007 WL 2744609, at *10).
32. *Id.* at *8.
33. *Id.*
34. *Id.* at *8-9.
35. *Id.* at *7.
36. *Id.* at *8 (quoting *Liberty Media*, 2011 WL 1632333, at *16).
37. *Id.*
38. *Id.* at *7.
39. *Id.* at *10 (quoting *In re Cencom Cable Income Partners, L.P.*, 2000 WL 130629, at *6 (Del. Ch. Jan. 27, 2000)).
40. *Id.* (quoting JV Agreement § 6.15).
41. *Id.* at *11.
42. *Id.* at *12.
43. *Id.* at *12-13.
44. 2007 WL 2744609 (Del. Ch. Sept. 14, 2007).
45. 925 A.2d 1265, 1280 and n.31 (Del. 2007) (observing that the exaltation of "form over substance" is a "proposition that courts, particularly courts of equity, are loathe to endorse. In the area of tax law, courts have enunciated various doctrines such as step transaction, business purpose, and substance over form, all of which allow the substantive realities of a transaction to determine the tax consequences") (citations omitted).
46. *Id.*

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