BNA, INC.

SECURITIES REGULATION & LAW

REPORT

OFFICERS AND DIRECTORS

2007 Developments in Delaware Corporation Law

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In a typical year, a handful of the varied areas that together comprise the Delaware corporation law will be further refined and developed, either through the legislative process (i.e., amendments to the Delaware General Corporation Law (the ''DGCL'')) or the judicial process (i.e., case law interpreting the DGCL or further constructing the code of conduct by which all players involved in a Delaware corporation must abide). In one sense, 2007 was no different from the typical year, as diverse areas of the Delaware corporation law have evolved.[1] As one steps back to reflect on 2007, however, it becomes clear that the areas of corporation law impacting how transaction attorneys guide their clients developed at a significant pace. Perhaps this is because those involved in the development of the Delaware corporation law faced two extremes with respect to the

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[1] For example, the Court of Chancery, in a number of opinions, addressed directors' fiduciary duties with respect to the granting of options. *See*, *e.g.*, *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007); *In re Tyson Foods, Inc.*, 919 A.2d 563 (Del. Ch. 2007); *In re Tyson Foods, Inc.*, 2007 Del. Ch. LEXIS 120 (Del. Ch. Aug. 15, 2007); *Conrad v. Blank*, 2007 Del. Ch. LEXIS 130 (Del. Ch. Sept. 7, 2007). Additionally, the Delaware Supreme Court addressed the right of creditors to bring claims against a director of a corporation that is insolvent or operating within the zone of insolvency, *N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), and the Delaware Court of Chancery held that a non-Delaware lawyer providing Delaware law advice to a Delaware corporation and causing documents to be filed with the Delaware Secretary of State is subject to the jurisdiction of the Delaware courts, *Sample v. Morgan*, 935 A.2d 1046 (Del. Ch. 2007). The Delaware legislature also made several substantive amendments to the DGCL in 2007 with regard to voting, clarifying that unless otherwise provided in a corporation's charter, if the charter provides a particular director with greater or lesser voting powers, those voting powers are applicable to such director's votes in committee or subcommittee settings, 8 *Del. C.* § 141(a), and that if a class or series of stock is granted a separate vote in the election of directors, such vote shall be a plurality unless otherwise provided in the charter or bylaws, 8 *Del. C.* § 216. In addition to the amendments made to the DGCL, the Delaware General Assembly amended the Delaware Constitution to allow the Delaware Supreme Court to answer questions of law certified to it by the U.S. Securities and Exchange Commission. For a more complete review of the 2007 amendments to the DGCL, see Jeffrey R. Wolters & James D. Honaker, *Analysis of the 2007 Amendments to the Delaware General Corporation Law*, CORPORATION (Aspen Publishers 2007).

transaction environment in 2007: the first half of the year was characterized by a boom in private equity-led leveraged buyouts, fueled by the availability of cheap debt, following which management would retain a stake in the then-private enterprise; the second half of the year was characterized by the fallout from the implosion of the credit market, making the terms of those LBO's entered into during the first half of the year no longer beneficial to the private equity sponsors and the banks backing them.

This article surveys some of the developments over the past year in the Delaware corporation law relating to transactions in the order that a transaction attorney would likely need to consider them. The article is not intended to be an exhaustive analysis of any one topic, or to cover all of the topics raised by any one case; rather, the article is intended to make readers aware of certain issues that are likely to guide them in putting together a transaction. As we hope becomes clear, if there is one overarching theme that ties together these developments, it is that although Delaware corporation law provides *guidelines* to transaction planners, each transaction is unique, and transaction attorneys should refer to these developments for what they are: the framework within which to captain the ship that is a transaction.

I. Step One—Exploring Strategic Alternatives

Of course, the first step in any transaction is finding a willing and able transaction partner. The Delaware Supreme Court has held that the business judgment rule[2] does not initially apply in situations where directors approve a transaction causing a change in control. In such cases, directors must show that they have acted reasonably and on a fully informed basis to ensure that the transaction offers the greatest short-term value reasonably obtainable for the stockholders. This is often referred to as the so-called *Revlon* duty.[3] Directors seeking to prove that they acted in conformity with their *Revlon* duties must prove that ''they were adequately informed and acted *reasonably*.''[4] Thus, ''the traditional inquiry of whether the Board was adequately informed and acted in good faith is heightened.''[5] Delaware courts, however, recognize the complexity involved in many board decisions taken during a review of a corporation's strategic alternatives:

> There are many business and financial considerations implicated in investigating and selecting the best value reasonably available. The board of directors is the corporation decisionmaking body best equipped to make these judgments. Accordingly, a court applying enhanced judicial scrutiny should be deciding whether the directors made **a reasonable** decision, not **a perfect** decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.[6]

The guidelines for what is ''reasonable'' in the context of a board's *Revlon* duties developed significantly over the past year. The three cases leading the charge in this development, *In re Netsmart Technologies, Inc. Shareholders Litigation*,[7] *In re The Topps Company Shareholders Litigation*[8] and *In re Lear Corporation Shareholder Litigation*,[9] all reflect what the Delaware Court of Chancery described as ''a microcosm of [the then] current dynamic in the mergers and acquisitions market''[10]—a target corporation agrees to be acquired by a private equity firm in a transaction through which the public stockholders are cashed out and management, through a form of rollover package, is given a ''second bite at the apple.''[11] In the following subsections, we discuss some of the specific topics addressed by these cases.

A. Strategic Buyers Versus Financial Buyers.

One of the key issues in each of these three cases was whether it is permissible to treat strategic buyers differently from financial buyers.[12] Guiding the courts' analysis of this issue was the perception that, in many cases, management would prefer a financial buyer to a strategic buyer, primarily because a buyer in the business of buying and selling businesses would be more likely to retain management following the transaction while a strategic buyer which is in the same or similar business as the target would be more likely to have a management team in place.[13]

Of course, a seller has legitimate business reasons to be more wary of approaching strategic buyers than financial buyers—strategic buyers are more likely to be competitors of the seller and thus more likely to use confidential information obtained in the due diligence process for nefarious purposes or even to game the process to prevent another competitor from succeeding as

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[2] In general terms, the business judgment rule provides that a decision by a disinterested board of directors, which is made with reasonable awareness of all reasonably available material information, and which is in good faith furtherance of a rational corporate purpose, will not be ''second guessed'' by the courts. *See, e.g.*, *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (holding that ''a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose' '') (internal citation omitted).

[3] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

[4] *In re The MONY Group Inc. S'holder Litig.*, 852 A.2d 9, 19 (Del. Ch. 2004).

[5] *Id.*

[6] *Paramount Commcn's, Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).

[7] 924 A.2d 171 (Del. Ch. 2007).

[8] 926 A.2d 58 (Del. Ch. 2007).

[9] 926 A.2d 94 (Del. Ch. 2007).

[10] *In re Netsmart*, 924 A.2d at 175.

[11] *Id.* at 198.

[12] Such differential treatment may include only approaching financial buyers, requiring a more detailed confidentiality agreement from strategic buyers, creating separate data rooms for strategic buyers and financial buyers and crafting higher gating functions for strategic buyers to proceed to the next round in an auction process.

[13] *See id.* at 198-99 (''Here, while there is no basis to perceive that [CEO] Conway or his managerial subordinates tilted the competition among the private equity bidders, there is a basis to perceive that management favored the private equity route over the strategic route. Members of management desired to continue as executives and they desired more equity. A larger strategic buyer would likely have had less interest in retaining all of them and would not have presented them with the potential for the same kind of second bite. The private equity route was therefore a clearly attractive one for management, all things considered.'').

   ISSN 0037-0665

the acquiror.[14] The opinions handed down in 2007 are significant in that the Court of Chancery recognized legitimate business concerns in dealing with a strategic buyer and counseled both sellers and buyers to work within these concerns. For example, in *Topps*, the Court criticized both the seller (Topps) and potential purchaser (Upper Deck, Topps' competitor) in their actions regarding the signing of a confidentiality agreement. The Court characterized the Topps board as ''hardly as receptive as one would expect'' following receipt of an overture from a strategic buyer who, ''given the likely synergies'' involved in a business combination, might ''be able to pay a materially higher price'' than a financial buyer.[15] At the same time, the Court noted that Upper Deck ''failed to acknowledge Topps's legitimate concerns about'' discussing a potential business combination with its competitor and stated that Upper Deck ''overreached'' in seeking to obtain the same information provided to a financial buyer.[16] Ultimately, the Court concluded that:

> Topps had to balance its concerns about the possibility that Upper Deck might use the Go Shop process as a pretext for gaining access to Topps's proprietary information with the possibility that Upper Deck might be willing to make higher bid [sic] than Eisner [, and that there] is a colorable argument that in the weeks that followed, Topps did not balance those concerns properly and rather relied on Upper Deck's status as a competitor as a pretext to keep Upper Deck at bay in order to preserve its friendly deal with Eisner.[17]

The lesson of these cases, we believe, is that a transaction planner ought not be hesitant to counsel a board that it is permissible to account for the realities of involving a strategic buyer in an auction; however, such counsel should be combined with advice that the board balance its concerns of dealing with strategic buyers against its duty to act *reasonably* to obtain the best short-term value for stockholders.

B. To Shop Or Take The Bird-In-Hand?

The Delaware courts have long recognized that there is no ''single blueprint'' to maximizing short-term stockholder value,[18] and that a decision to forgo a broad pre-signing auction is not necessarily a violation of a board's *Revlon* duties. Thus, in a number of cases, Delaware courts have blessed a process by which a board signs a merger agreement with a ''bird-in-hand'' suitor, which merger agreement allows for a post-signing market check. Such a market check has traditionally taken the form of a ''window-shop'' period prohibiting the target from soliciting alternative offers for the company, but allowing it to talk with potential suitors who actually approach it. Recently, merger agreements have begun to provide for more target-favorable ''go-shop'' post-signing market checks, in which the target is permitted actively to solicit offers for a period of time following signing of the bird-in-hand transaction.

The Court of Chancery had historically deferred to a disinterested board's decision regarding whether to take a bird-in-hand bid or whether to utilize a pre-signing auction. For example, in *McMillan v. Intercargo Corp.*, the Court of Chancery stated that ''[w]hether it is wiser for a disinterested board to take a public approach to selling a company versus a more discreet approach relying upon targeted marketing by an investment bank is the sort of business strategy question Delaware courts ordinarily do not answer.''[19] Similarly, in other prior decisions, the Court of Chancery deferred to a board decision to forgo a pre-signing auction in favor of a post-signing window-shop market check.[20] *Netsmart*, *Topps*, and *Lear* may, however, signal a trend toward increased scrutiny of the tactical choices of the board of a selling corporation.

Netsmart, characterized by the Court as a micro-cap public company (the transaction had an implied equity value of $115 million), received expressions of interest from various potential private equity buyers and entered into a merger agreement to be acquired by two such firms. The years preceding the execution of the merger agreement at issue involved both a broad, informal search for potential acquirors, spread over seven years, and, in 2006, a more formal, discrete search involving only seven private equity groups. In that initial seven-year span, a sale of Netsmart had been informally explored by Netsmart's CEO by way of informal and sporadic ''chats'' with others without confidentiality restrictions, as well as by Netsmart's banker by way of cold calls to a broad range of prospective clients in which it did not have authority to mention Netsmart's interest in a sale, in which there were no confidentiality restrictions, and in which Netsmart's name was mentioned along with the names of other companies.

After receiving overtures from private equity buyers in 2006, the Netsmart board focused on an auction involving a discrete set of potential private equity buyers. The auction moved rapidly and was narrowly focused. After the special committee was formed, it immediately decided to reach out to seven private equity groups. Four of the private equity firms ultimately bid on Netsmart by the date required for initial bids. The special committee gave the two highest bidders the opportunity to conduct additional diligence, and, after receiving disappointing bids from those two firms, allowed In-

[14] In addition, rightly or wrongly, there may be a perception that strategic buyers are less likely than financial buyers to maintain the confidentiality of the process. The Court of Chancery has expressed skepticism on this point. *See Berg v. Ellison*, Civ. A. No. 2949-VCS (Del. Ch. June 12, 2007) (transcript) at 12 (''I don't necessarily embrace the idea that, as I said, that private equity buyers are the supersecret people you can tell your most intimate thoughts to with the greater confidence that they won't reveal them than people who are actually in the business of working for companies that make real products and deliver real services.'').

[15] *In re Topps*, 926 A.2d at 87-88.

[16] *Id.*

[17] *Id. See also Berg v. Ellison*, Civ. A. No. 2949-VCS (Del. Ch. June 12, 2007) (transcript) at 12 (''I recognize that there are legitimate reasons from—you know, in particular circumstances you might not shop to strategics who might be your competitors.'').

[18] *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

[19] *McMillan v. Intercargo Corp.*, 768 A.2d 492, 505 (Del. Ch. 2000).

[20] *See, e.g.*, *In re The MONY Group Inc. S'holders Litig.*, 852 A.2d 9 (Del. Ch. 2004) (upholding a five-month post-signing market check); *In re Pennaco Energy, Inc. S'holders Litig.*, 787 A.2d 691, 693 (Del. Ch. 2001) (board met its fiduciary duties by subjecting the transaction to a post-signing market check ''unobstructed by onerous deal protection measures that would impede a topping bid''); *In re Fort Howard Corp. S'holders Litig.*, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988) (special committee fulfilled its fiduciary duties by negotiating provisions intended to permit an effective six-week market check prior to closing of the transaction).

sight Venture Partners, another of the original four bidding firms, to conduct additional diligence and make another offer. Insight's offer was the highest and negotiations over the merger agreement ensued. The special committee sought the opportunity to shop the company through a post-signing market check by way of a go-shop clause, but ultimately, the merger agreement provided not for a go-shop period, but for a post-signing window-shop period.

In *Topps*, the target board opted to forgo a public auction process prior to signing a definitive agreement with a financial buyer. The board's decision was based upon skepticism that an auction process would result in a more attractive proposal than the bird-in-hand proposal it currently had; the fact that the bird-in-hand suitor had indicated it would withdraw its offer if an auction commenced; and concern over the effect of a failed auction. Although the board had reviewed its strategic alternatives in 2004, had survived two proxy contests, had auctioned a portion of its business in 2005, and had attracted unsolicited offers from two financial buyers in May and June of 2006, the board had not run a formal pre-signing auction and, in fact, the target's CEO issued a letter in July 2006 stating that the target ''was not interested in a sale 'at this time' as a 'quick fix.' ''[21] Unlike *Netsmart*, in *Topps* the target successfully negotiated for a go-shop period.[22]

Similarly, in *Lear*, a target board signed up a merger agreement providing for a go-shop process without completing a full pre-signing auction. However, the Lear board did authorize a limited pre-signing market check during which an investment banker contacted eight financial buyers. In addition, two previous investments by Carl Icahn coupled with the elimination of Lear's poison pill had signaled to the market that Lear might be in play. In recommending that Lear forgo a broad-based pre-signing auction, a special transaction committee of the board relied on the premiums to market represented by the bird-in-hand bid, an investment bank's fairness opinion, an assessment of the industry by an independent industry expert, the discrete pre-signing market check, and the go-shop process permitted by the merger agreement.[23]

In each of *Netsmart*, *Topps*, and *Lear*, the Court of Chancery ultimately did not enjoin the transaction solely because of the decision to enter into a merger agreement with the bird-in-hand suitor in lieu of a broad pre-signing auction. In each case, however, the Court undertook a detailed review of the decision-making process leading to the decision to forgo a pre-signing auction, and, in the case of *Netsmart*, the Court enjoined a vote on the merger, holding that the plaintiffs demonstrated a reasonable probability of success in showing that the board had not satisfied its *Revlon* duties.

In *Netsmart*, the Court first addressed the informal, decade-spanning search undertaken by the board. Although the Netsmart board pointed to the lack of a suitor developing out of these conversations as a reason for forgoing a broad pre-signing market check, the Court stated that ''[t]he decade-spanning, sporadic chats by [the CEO and banker] are hardly the stuff of a reliable market check,'' especially given that ''Netsmart itself had been transformed through a host of acquisitions and lucrative contracts over that extended period.'' Further, there had been no ''serious sifting of the strategic market to develop a core list of larger healthcare IT players for whom an acquisition of Netsmart might make sense.''[24]

The *Netsmart* opinion was also critical of the board's decision to limit its search to private equity groups and found that, in light of all the circumstances, the post-signing window-shop market check did not satisfy the board's *Revlon* duties:

> Precisely because of the various problems Netsmart's management identified as making it difficult for it to attract market attention as a micro-cap public company, an inert, implicit post-signing market check does not, on this record, suffice as a reliable way to survey interest by strategic players. Rather, to test the market for strategic buyers in a reliable fashion, one would expect a material effort at salesmanship to occur.[25]

Given these circumstances, including the micro-cap nature of the company and the failure of the board to seek out strategic purchasers in addition to private equity firms, the Court found that the plaintiffs had a reasonable probability of proving that the board violated its *Revlon* duties.[26]

In *Topps*, although the Court found the board's initial decision to take the bird-in-hand offer reasonable, the Court criticized both the board's conduct during the go-shop process and the disclosures made regarding the process. During the go-shop process, only one serious suitor, Upper Deck, emerged. The Court, while ac-

[21] *In re Topps*, 926 A.2d at 68.

[22] The go-shop provision in the merger agreement included a 40-day solicitation period, created a post-go-shop ''window-shop'' structure, provided for a four-day match period (to restart with any material revision to a superior proposal) prior to allowing the bird-in-hand merger agreement to be terminated, and provided for a two-tier termination fee of up to approximately 3% of deal value (inclusive of expenses) for a termination during the go-shop process and of up to approximately 4.6% of deal value (inclusive of expenses) for a termination following the go-shop process.

The efficacy of a go-shop period is based upon the myriad provisions comprising it. For example, in *Berg v. Ellison*, a 25-day go-shop period included a two-tier termination fee and a match right for the buyer. The Court disregarded the lower termination fee on the assumption that the only way that fee would apply was in the case of a fully signed deal, as opposed to simply showing up during the go-shop period. *See Berg v. Ellison*, Civ. A. No. 2949-VCS (Del. Ch. June 12, 2007) (transcript), at 4-5 (''I don't give a lot of weight to a 25-day—the lower break-up fee during a 25-day go-shop period. That just strikes me as a situation—of if you make a blind bid, if you're willing to essentially make a bid without a topping bid without due diligence, you get a lower break-up fee.'').

[23] The go-shop provision in the Lear merger agreement contained a 45-day solicitation period, a post-go-shop ''window-shop'' period, a complicated matching right for the acquiror (to continually restart for up to 10 days with any material revision to the superior proposal unless the superior proposal is more than $1.00 greater than the bird-in-hand proposal), and a two-tier termination fee of up to approximately 2.8% of equity value (inclusive of expenses) for a termination during the go-shop process and of up to approximately 3.52% of the equity value (inclusive of expenses) for a termination following the go-shop process.

[24] *In re Netsmart*, 924 A.2d at 196.

[25] *Id.* at 197.

[26] *Id.* at 199.

  SRLR ISSN 0037-0665

knowledging ''legitimate concerns about entering into serious discussions with [the company's] only . . . competitor,'' found that the company's conduct with respect to the potential suitor evidenced a lack of enthusiasm that ''regrettably suggests that the Topps Incumbent Directors favored [the bird-in-hand suitor], who they perceived as a friendly suitor who had pledged to retain management and would continue [the CEO] and his family in an influential role.''[27] Because (1) the potential strategic suitor had signed a confidentiality agreement containing a standstill prohibiting it from publicly disclosing information regarding its acquisition proposal as well as from acquiring Topps' common stock absent company consent; (2) the recital of the suitor's bidding process in the Topps proxy statement diverged from the suitor's version of events; (3) the standstill agreement contained a fiduciary out; (4) the suitor had submitted a bid that apparently could lead to a superior proposal; and (5) the Topps directors did not pursue the potential for a higher value with the potential suitor, the Court found ''a reasonable probability of success on [plaintiffs'] claim that the Topps board is misusing the standstill.'' The Court thus issued a limited injunction requiring Topps to grant a waiver of the standstill agreement to allow the suitor to make a tender offer to stockholders containing a price and conditions no less favorable to Topps than that contained in the suitor's last bid and to communicate its version of relevant events to the Topps stockholders.[28] In addition, the Court ordered additional disclosure regarding the financial advisor's analyses and the acquiror's general discussions and indications to management that the acquiror would retain management following the going-private transaction.[29]

Finally, in *Lear*, the Court criticized the process leading to the definitive merger agreement because the committee allowed the company CEO (who could benefit from the renegotiation of retirement benefits once the company was privately held) to negotiate the merger agreement and described that approach as ''less than confidence-inspiring.''[30] With respect to taking the bird-in-hand bid, the Court noted that ''[a]lthough a formal auction was the clearest way to signal a desire for bids, it also presented the risk of losing Ichan's $36 bid.''[31] The Court found the committee's decision to take the bird-in-hand bid reasonable in light of the prior signals that the Company was in play (*e.g*, the public removal of the corporation's poison pill, and Ichan's previous investments in the Company) and the lack of other overtures prior to Ichan's overture. Thus, the Court declined to issue a broad injunction, opting instead to issue a limited injunction requiring disclosure of the ''important economic motivation of the negotiator singularly employed by a board to obtain the best price for the stockholders,'' given that ''that motivation could rationally lead that negotiator to favor a deal at a less than optimal price, because the procession of a deal was more important to him, given his overall economic interest, than only doing a deal at the right price.''[32]

[27] *In re Topps*, 926 A.2d at 88.
[28] *Id.* at 91.
[29] *Id.*
[30] *In re Lear*, 926 A.2d at 116.
[31] *Id.* at 119.
[32] *Id.* at 114-15, 118.

The depth of analyses in these cases at first blush suggested a significant tightening of the *Revlon* standard as that standard was described by the Delaware Supreme Court in *QVC*.[33] With the benefit of hindsight, and the end of the unique M&A conditions prevalent in early 2007, however, we believe that these cases may be best viewed as a product of their times and a reminder that although courts will defer to reasonable decisions of a board of directors, reasonableness has been, and will continue to be, a fact-specific analysis.[34] Or, as the Court stated in *Netsmart*:

> An important recent decision of this court emphasizes that the reasonableness of a board's decisions in the M&A context turns on the circumstances. . . . Not being cabined by a long set of per se rules, boards have great flexibility to address the particular circumstances they confront. But equitable principles, including the heightened reasonableness standard in *Revlon*, ensure that this broad discretion is not abused.[35]

C. Avoiding Conflicts.

Netsmart, *Topps*, and *Lear* also are instructive for transaction attorneys in that, in each of these cases, a number of common potential conflict scenarios arose, giving the Court an opportunity to comment on the handling of such conflicts.

1. Management Discussions.

Almost inevitably, in our experience, management of the target or one of the potential suitors will seek an understanding as to management's role in the surviving entity. Oftentimes, such conversations are beneficial to the strategic process, as the potential suitors may attach value to the retention of the individuals comprising the management team. Inherent in such conversations, however, are potential conflicts in that (a) any retention package may be viewed by the potential suitor as part of the consideration for the entire corporation, and thus may come at the stockholders' expense and (b) management may be incentivized to tilt the process toward the suitor offering the best retention package. *Netsmart*, *Topps* and *Lear* all provide guidance to deal lawyers seeking to balance the advantages and disadvantages of conversations over such retention packages.

The relevant chronology of events in *Netsmart* was as follows: Netsmart entered into an exclusivity agreement with Insight in exchange for its obligation to deliver a draft merger agreement with a set price by October 23. At the end of October, negotiations regarding the merger agreement ensued between Insight and the Netsmart special committee. At the same time, and without involvement of the special committee, the Netsmart CEO and other members of management be-

[33] *See supra* note 6.
[34] *See Guttman v. McGinnis*, C.A. No. 3450-VCL, transcript at 24-25 (Del. Ch. Jan. 14, 2008) (''Now that we are here in January of 2008, as everyone knows, the period of intense activity by private equity companies in taking a company private, in transactions in which the company managers often were significant participants in the equity of the surviving entity, seems to have come to a screeching halt. . . . Rather than a private equity deal, the proposed transaction in this case is a strategic buyer. Yet, when I read the complaint and the papers that the plaintiffs submitted, the arguments advanced really are sort of weak echoes of concerns the Court has expressed in connection with the private equity transactions.'').
[35] *In re Netsmart*, 924 A.2d at 197 n.80.

gan negotiating their employment agreements with Insight. By November 15, these ''parallel'' talks between the special committee and Insight with regard to the merger agreement on one hand, and Netsmart management and Insight on the other, were completed. The merger agreement was thereafter executed on November 18, along with new employment agreements for the Netsmart CEO and certain members of management that would become effective if the merger were approved.[36]

In discussing the chronology of events, the Court expressed concern over the level of contact between the CEO and the private equity buyers:

> One obvious reason for concern is the possibility that some bidders might desire to retain existing management or to provide them with future incentives while others might not. In this respect, the Netsmart Special Committee was also less than ideally engaged. [CEO] Conway was left unattended to bandy such issues around with the invited bidders.[37]

Ultimately, the Court was unconvinced that the board breached its *Revlon* duties simply by allowing such talks to occur.[38] The Vice Chancellor, however, expressly qualified that finding by noting that there was no other evidence of pre-existing relationships or that management received a materially greater offer from any one private equity bidder.[39] Moreover, the depth of the Court's analysis is of note, given that the benefits received by the CEO were quite modest.[40]

In contrast, in both *Topps* and *Lear*, the Court of Chancery enjoined stockholder votes on the transaction until the target corporation issued supplemental disclosures addressing the extent of management contact with bidders. During the year leading up to the Topps merger agreement, Topps had experienced poor financial performance and a proxy contest that threatened to unseat then-CEO Arthur Shorin. It was at this early point that Michael Eisner first contacted Shorin about how he could be ''helpful'' with a possible going private transaction.[41] The company's proxy statement disclosed that management was specifically told not to speak with Eisner concerning future employment agreements prior to signing the merger agreement and that in fact no discussions had taken place.[42] The Court found, however, that Eisner had repeatedly expressed throughout the negotiation process his desire to retain existing management.[43] The Court also pointed to evidence that Eisner had personally contacted management, referencing a conference call with members of Topps management prior to execution of the definitive merger agreement where Eisner ''personally reiterate[d] [his] assurances about management's likely future.''[44] The Court found that the Company's proxy materials were only true in a ''misleadingly literal sense'' and therefore required a fuller disclosure of Eisner's assurances about management's future.[45]

In *Lear*, the Court again required supplemental disclosures concerning assurances that management received from a financial sponsor. In January 2007, Carl Icahn approached Lear CEO Robert Rossiter about the possibility of acquiring Lear in a going private transaction. Even after a special committee was formed to oversee the merger process, Rossiter led the negotiations of the terms of the agreement with Icahn. Over the course of negotiations, Icahn requested that senior management remain with the company following the transaction. To that end, he demanded that management be allowed to execute new employment agreements as a condition to closing of the merger.[46] In response, the special committee decided to allow management to participate in supervised talks with Icahn. However, the special committee refused to make those agreements a condition to closing and expressly required management to get board approval before entering into any final agreements. As a result, management began negotiating aspects of their employment agreements several days prior to the signing of the merger agreement.

In discussing the actions leading up to the merger agreement, the Court focused on the motives of management, specifically those of Rossiter. The Court recognized Rossiter's incentive to pursue a deal with Icahn, especially given the 61-year-old executive's earlier attempts to secure his personal financial position post retirement.[47] The Vice Chancellor noted that, at the very least, the committee should have supervised Rossiter more closely to prevent ''inappropriate discussions that would taint the process.''[48] The Court, however, refused to enjoin the transaction solely on the plaintiff's *Revlon* claim, merely opining that the process employed was ''far from ideal'' and ''unnecessarily raise[d] concerns about the integrity and skill of those trying to represent Lear's public investors.''[49] Notably, the Court did not fault the special committee's decision to let Rossiter and other members of management negotiate terms of their employment agreements prior to the signing of the merger agreement. Though these contacts took place prior to the market check period, they were supervised by counsel and any amendments to the management's employment terms were strictly subject to board consent.

The ''gold standard'' for dealing with this form of potential conflict may be the actions discussed in *In re Toys ''R'' Us, Inc. Shareholder Litigation.*[50] In *Toys ''R''Us*, CEO John J. Eyler, Jr. ''expressly refused to discuss his future with any bidder, and made sure that other members of management also refrained from doing so.''[51] After an extended auction process, the board entered into a merger agreement in mid-March 2005 with a consortium of private equity firms which allowed for a window-shop period.[52] For nearly two months into the window-shop period, Eyler and the other members of management declined to discuss aspects of their em-

[36] *Id*. at 190-91.
[37] *Id.* at 194.
[38] *Id.*
[39] *Id.*
[40] *Id.* at 190.
[41] *In re Topps*, 926 A.2d at 61.
[42] *Id.* at 74.
[43] *Id.*
[44] *Id.*
[45] *Id.* at 74.
[46] *See* Lear Corp., Definitive Proxy Statement (Sched. 14A), at 20 (May 23, 2007).
[47] *In re Lear*, 926 A.2d at 115-17.
[48] *Id.* at 117.
[49] *Id.* at 117-18.
[50] *In re Toys ''R'' Us, Inc. S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005).
[51] *Id.* at 1004.
[52] *Id.* at 993.

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ployment agreements with the buyer.[53] It was not until early-May 2005 that the buyer began contacting members of the management team[54] and no agreements with management were completed as of the date of the Company's final proxy statement on May 23, 2005.[55] The Court noted that Eyler, ''having adamantly refused to create an appearance problem by talking with bidders about his future,'' ended up without an offer to stay with the company following the merger.[56] The Court approvingly noted that management made a concerted effort to run a ''pure process'' free of management interference.[57]

Such a ''gold standard'' process, however, might not be the most efficient way to maximize stockholder value in all situations. It may be, for example, that potential suitors wish to ensure that management roll over their equity into new equity in the surviving entity. Alternatively, the seller's board might conclude that management buy-in into the strategic process is essential and that such buy-in is best ensured by allowing discussions with bidders. Again, these cases remind deal lawyers that the decisions made in the course of a strategic process are context-specific and that the best counsel may simply be to encourage clients to take all factors into account and to make a decision independent of management influence.

2. Management Involvement In Due Diligence Process.

In the course of critiquing the process employed by the special committee in *Netsmart*, the Court also commented on the role of management in the due diligence process. Specifically, Vice Chancellor Strine expressed concern over a special committee that was ''less than ideally engaged'' and that repeatedly deferred to management.[58] Following what the Court would characterize as a ''pattern throughout'' the process, the committee allowed management to run the due diligence process with little involvement by it or its advisors.[59] The Court stated that under ''easily imagined circumstances'' such an approach to due diligence could be ''highly problematic,'' opining that:

> If management had an incentive to favor a particular bidder (or type of bidder), it could use the due diligence process to its advantage, by using different body language and verbal emphasis with different bidders. 'She's fine' can mean different things depending on how it is said.[60]

Fortunately, this potential conflict has a remedy that is often acceptable to all constituencies—asking the banker to the special committee to have a representative present throughout the due diligence process and at management presentations.

3. Banker Conflicts.

Of course, having a banker to the special committee present throughout the due diligence process and at management presentations will only help prevent conflicts to the extent the banker itself is not under an improper influence from management. In *Netsmart*, the special committee used management's longstanding investment banker in connection with its process. That same investment banker had not only represented management in a 2005 acquisition of a competitor, but, for the past several years, had also sought potential acquirors on behalf of management.

The Court directly questioned where the investment bank owed its true loyalties, noting that for the investment banker ''[t]he path of dealing with a discrete set of private equity players was attractive to its primary client contact—management—and the quickest (and lowest cost) route to a definitive sales agreement.''[61] The Court stated that one ''rationally doubts'' how confidential the committee's executive sessions were given the banker's ongoing relationship with management.[62]

As with other *potential* conflict situations, the decision to use a corporation's historic banker may actually benefit the process: such a banker may have unique insight into the company from its previous work and thus may be able to get up to speed faster than a ''fully independent'' banker—an advantage that may be extremely important if an expedited sale process is desired. Again, these cases remind deal lawyers to advise their clients to consider all alternatives in order to make a fully informed, disinterested decision.

4. Note On Using Stapled Finance.

In the context of some strategic processes, especially where financial buyers—who rely on the availability of debt to fund their acquisitions—are solicited, investment bankers provide ''stapled financing''—i.e., informing potential suitors that debt financing is available for the transaction from the sell-side investment bank. The Court has previously expressed some concern over the use of stapled financing, stating that such financing ''tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms.''[63] Still, the same Court explicitly cautioned against a bright-line rule against the use of such financing practices. Envisioning scenarios in which such dual roles for an investment banker could be ''wholly consistent with the best interests of the primary client company,'' the Court simply noted that, in general, ''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.''[64]

It bears note that in *Lear*,[65] the Court tacitly approved the use of stapled financing. There, the Court took the occasion to comment on the credibility of a potential buyer while discussing the adequacy of the ''go-shop'' period. One of the reasons the bidder never made an offer, the Court noted, was an inability to find equity partners to help finance a potential acquisition. In dismissing the bidder as a credible buyer, the Court noted that it refused an offer of stapled financing by Lear's primary financial advisor, JPMorgan, but did not criticize JPMorgan's offering of that financing.[66] Although not an endorsement of stapled financing in all circum-

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[53] *See* Toys ''R'' Us, Inc., Definitive Proxy Statement (Sched. 14A) (May 23, 2005).
[54] *Id.*
[55] *Id.*
[56] *Toys ''R'' Us*, 877 A.2d at 1004.
[57] *Id.* at 1004 n.43.
[58] *Netsmart*, 924 A.2d at 194.
[59] *Id.* at 188.
[60] *Id.* at 194.
[61] *Id.* at 199.
[62] *Id.* at 193.
[63] *Toys ''R'' Us*, 877 A.2d at 1006.
[64] *Id.* n.46.
[65] 926 A.2d 94.
[66] *Id.* at 106.

stances, *Lear* may be viewed as an affirmation of the "no bright-line" concept previously set forth by the Court.

II. Step Two—Crafting the Deal: Deal Protection Devices

The previous section of this article touched on important considerations in finding a transaction partner. We now turn to a sampling of issues that deal lawyers confront in crafting merger agreements with potential transaction partners that Delaware courts addressed in 2007.[67]

A. "No Bright-line" Rule In Evaluating Deal Protection Measures.

In *Louisiana Municipal Police Employees' Retirement System v. Crawford*,[68] the Court of Chancery rejected the use of a bright-line test in determining the reasonableness of deal protection devices. The merger agreement in that case—which provided for a stock-for-stock merger of the constituent corporations—included a "full complement of deal-protection devices," including a window-shop provision that limited the ability to court other bidders and a "force the vote" provision that required each board to submit the merger agreement to its respective stockholders.[69] The deal also included a $675 million reciprocal termination fee that was triggered if either board withdrew from the deal or changed its recommendation to its stockholders. In explaining their accession to these deal protection devices to the Court, the defendants pointed to prior case law, noting that similar deal provisions had been upheld in the past. With regard to the termination fee, for example, the defendants cited a number of Delaware cases recognizing a similar percentage of deal value as reasonable.

The Court, however, expressly rejected the concept of a bright-line rule as to what constitutes permissible deal protections:

> Defendants attempt to build a bright line rule upon treacherous foundations, relying upon carefully-selected comments to contradict a clear principle of Delaware law. Our Courts do not "presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal. Rather, a Court focuses upon "the real world risks and prospects confronting [directors] when they agreed to the deal protections."[70]

The Court went on to opine that "[t]he inquiry, by its very nature [is] fact intensive [and] cannot be reduced to a mathematical equation."[71] Addressing termination fees in particular, the Court said that while a blanket rule at 3% for termination fees might serve as an easy guide for deal lawyers, "it is simply too blunt an instrument, too subject to abuse, for this Court to bless. . ."[72]

After rejecting a bright-line test,[73] the Court provided a series of factors that could instead be considered in assessing the permissibility of deal protections. These factors include (1) the overall size of the termination fee and its percentage of the deal value, (2) the benefit to stockholders, including any premium over the share price that the directors seek to protect, (3) the absolute size of the deal and the relative size of the merger participants, (4) the extent to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power, and (5) the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole.[74]

B. Standstill Provisions.

Most merger agreements contain a list of actions that a target corporation may not take absent buyer approval. Often among these provisions is a negative covenant against waiving any standstill agreements to which the target is a party. Because targets almost always require the execution of a confidentiality agreement containing a standstill provision as a condition to receiving confidential information, the effect of such a provision is to prohibit any potential suitors with whom the target discussed a potential transaction prior to signing the merger agreement from reengaging the target or from making a topping bid. Many times, such negative covenants are "subject to" the target board's fiduciary duties (either expressly or by reference to the window-shop or go-shop provisions).

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[67] In the change of control context, the merger agreement terms for which a board negotiates may be taken into account in determining whether a board acted in conformity with its *Revlon* duties (*e.g.*, by providing for an adequate post-signing market check). Even outside of this context, a court applying Delaware law will apply heightened scrutiny to any deal term seen as "protective" of the transaction (*e.g.*, termination fees, matching rights, etc.) to ensure that such provisions are not preclusive or coercive of the stockholder vote, and to ensure that such provisions are within a "range of reasonableness." *See, e.g.*, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) (applying *Unocal* standard of enhanced scrutiny to board's adoption of deal protections when such "defensive measures" were challenged in context of competing higher bid).

[68] *La. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172 (Del. Ch. 2007) ("*LAMPERS*" or "*Caremark*").

[69] *Id.* at 1180.

[70] *Id.* at 1181 n.10 (quoting *In re Toys "R" Us, Inc., S'holder Litig.*, 877 A.2d 975, 1016 (Del. Ch. 2005)).

[71] *Id.*

[72] *Id.*

[73] A similar theme emerged in *Netsmart*. *See id.*, 924 A.2d at 197 ("The problem with this argument is that it depends on the rote application of an approach typical of large-cap deals in a micro-cap environment. The 'no single blueprint' mantra is not a one way principle. The mere fact that a technique was used in different market circumstances by another board and approved by the court does not mean that it is reasonable in other circumstances that involve very different market dynamics.").

[74] *LAMPERS*, 918 A.2d at 1181 n.10. Although *Caremark* makes clear that there is no bright-line rule in analyzing deal protection measures, in *Berg v. Ellison*, the Court suggested that a go-shop provision containing a combination of a five percent termination fee and a match right would raise the Court's suspicion. *Berg v. Ellison*, Civ. A. No. 2949-VCS (Del. Ch. June 12, 2007) (transcript) at 12. *Berg* is the transcript of a hearing on a motion to expedite. During the hearing, the Court indicated it would have been troubled by such a combination of deal protection measures and likely to expedite the litigation. However, the plaintiff in *Berg* miscalculated the termination fee, which was actually closer to 3 or 3.5 percent and the Court declined to expedite proceedings. *See also Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, 1999 Del. Ch. LEXIS 202, at *5 (Del. Ch. Sept. 27, 1999) (characterizing in dicta a 6.3 percent fee as "stretch[ing] the definition of range of reasonableness," probably "beyond its breaking point").

The merger agreement in *Topps* contained such a negative covenant, subject to a fiduciary out. The Court in *Topps* criticized Topps' decision not to waive its standstill agreement with Upper Deck in order to allow Upper Deck to communicate with Topps stockholders and make a topping tender offer, and held it was likely that plaintiffs would prevail on their claim that the board breached its *Revlon* duties by refusing to negotiate in good faith with Upper Deck and by not releasing Upper Deck from the standstill. In doing so, the Court made two important observations.

First, the Court observed that standstill agreements are an important part of an auction process, but that the use of such agreements is generally subject to a board's fiduciary duties.[75] This observation suggests that the Court would assess whether waiving a standstill was required by a board's fiduciary duties at the time a potential topping bidder sought a waiver, which in turn suggests that a negative covenant against waiving standstills must always be subject to a board's fiduciary duties. However, the Court also observed that there may be situations where agreeing to an unconditional negative covenant against waiving standstills is permissible:

> Contemplate, for example, a final round auction involving three credible, but now tired bidders, who emerged from a broad market canvass. One can easily imagine how a board striving in good faith to extract the last dollar they could for their stockholders might promise the three remaining bidders that the top bidder at 8:00 p.m. on the next Friday will get very strong deal protections including a promise from the target not to waive the Standstill as to the losers.[76]

Whether a given set of facts will allow for a negative covenant against waiving a standstill agreement, with or without a fiduciary out, appears to be a case-by-case analysis. The *Topps* dicta does indicate that a fiduciary out may not always be necessary; however the safest course for targets would seem to be to include one.

C. Calculating Termination Fees.

The numerical percentage of a termination fee does not reveal much without knowing what the fee is a percentage of. In prior case law, Delaware courts had calculated termination fees based both on "equity" and "enterprise" values. Calculations relying on "equity value" merely look at the equity or market capitalization of a firm (typically based on per-share deal price), whereas "enterprise value" incorporates the value of the firm's debt by adding it to the overall "cost" borne by the acquiror.

In *Lear*, Vice Chancellor Strine suggested that "enterprise value" is "arguably [the] more important" metric in determining whether a termination fee is preclusive, on the premise that "most acquisitions require the buyer to pay for the company's equity and refinance all of its debt."[77] Similarly, in *Berg*, Vice Chancellor Strine suggested that the numerical percentage represented by the termination fee should be based on the total cost borne by the acquiror, and that equity should be calculated on a fully-diluted basis.[78] The statements in both *Lear* and *Berg* are *dicta*; however, they provide some indication that the courts consider the cost of acquiring a target as the appropriate metric for determining the percentage value of a termination fee.

D. Indemnification Provisions.

Merger agreements typically contain provisions providing indemnification rights for the target's directors. These provisions frequently contain some combination of the following obligations: for the buyer (i) to maintain in the surviving company's charter and bylaws indemnification provisions no less favorable to the target's directors than those in effect at the time of the merger; (ii) to guarantee the surviving corporation's indemnification obligations to the target's directors; (iii) to maintain the current level of D&O insurance; and (iv) to provide indemnification rights directly from the buyer to the target directors. With respect to this final requirement, receiving indemnification rights from the buyer, as opposed to the surviving entity, is beneficial to directors in that, because the buyer is a third party, the indemnification rights conferred on the directors from buyer are likely not subject to the requirement, contained in Section 145 of the DGCL, that the directors be deemed to have acted in good faith in order to be entitled to indemnification.[79]

In *Caremark*, the Court suggested that, in certain circumstances, if the directors obtain indemnification rights directly from the buyer, thus avoiding the Section 145 good faith limitation, they may be considered "interested" directors. In *Caremark*, the directors of the target board faced possible liability for alleged option backdating, and the merger agreement provided that the combined company would indemnify "all past and present directors of Caremark either 'to the same extent such individuals are indemnified pursuant to Caremark's certificate of incorporation and bylaws in effect as of the date of the merger agreement' or 'to the fullest extent permitted by law.' "[80] The Court stated:

> That the indemnification is not merely coterminous with Caremark's former indemnification, but spans "the fullest extent permitted by law," may be quietly critical. . . . . In effect, CVS shareholders are offering to indemnify Caremark directors. Were a backdating case later to come to trial, Caremark directors would almost certainly argue that Delaware statutory law puts no direct limitation on such beneficence.
>
> Expanded indemnification may be more important for independent directors when they are subject to claims for backdating of executive stock options. . . . . Such directors may face considerable personal loss if found liable, making indemnification that much more important to them, although in most cases the recipient of any ill-gotten gains will also be liable, if not under a theory of breach of fiduciary duty, then for unjust enrichment.[81]

Such an inference of director interest seems contrary to precedent. Prior Delaware law had held that:

> Normally, the receipt of indemnification is not deemed to taint related director actions with a presumption of self-interest. That is because indemnification has become com-

[75] *Topps*, 926 A.2d at 91 ("Although the Standstill is a contract, the Topps board is bound to use its contractual power under that contract only for proper purposes.").

[76] *Id.* at 91 n.28.

[77] 926 A.2d at 120.

[78] *Berg v. Ellison*, Civ. A. No. 2949-VCS (Del. Ch. June 12, 2007) (transcript) at 11 (calculating termination fee based on fully diluted value (including exercise of options), so that it reflects "the actual acquisition costs of the acquirer").

[79] The general rule in Section 145(b) of the DGCL against indemnification for losses in derivative suits would also appear to be inapplicable.

[80] *LAMPERS*, 918 A.2d at 1180.

[81] *Id.* at 1180 n.8.

monplace in corporate affairs . . . and because indemnification does not increase a director's wealth.[82]

In *Globis Partners, L.P. v. Plumtree Software, Inc.*, the Court of Chancery applied the older precedent in finding "no basis for inferring the receipt of indemnification benefits is material, or likely to taint the Individual Defendants' judgment."[83]

Caremark and *Plumtree* are distinguishable from one another in that, in *Caremark*, the Chancellor observed that the directors "may face considerable personal loss if found liable [on stock backdating claims],"[84] whereas in *Plumtree*, Vice Chancellor Parsons expressly held that the plaintiffs failed to allege that the directors faced a substantial likelihood of liability in connection with a government contract. Although indemnification provisions are common, *Caremark* serves as a reminder that even such common provisions may be so material to certain directors as to deem them interested in the transaction.

III. Step Three—Obtaining Stockholder Approval

Once the transaction documents are executed, a board turns its attention to stockholder approval of the transaction. As the Court of Chancery has stated:

> [O]nce a board of directors deems a merger agreement favorable, it may employ various legal powers to achieve a favorable outcome on a shareholder vote required to approve that agreement. Directors can spend the corporation's money on printing and distributing a proxy statement explaining their judgment as to the benefits of the merger proposal. They can retain experts to solicit proxies and publicize their views. They can hire lawyers and other advisors to defend their actions in court or in front of administrative or legislative bodies.
>
> While recognizing the board's power to take such action, equity necessarily limits what a board of directors can do in its attempt to achieve shareholder approval of such a transaction. As is well known, "inequitable action does not become permissible simply because it is legally possible." . . . Ordinarily, if a clear majority of stockholders has voiced disapproval of the transaction, the board may not take steps to "thwart [that] shareholder majority."[85]

In *Mercier v. Inter-Tel (Delaware), Inc.*,[86] the Court of Chancery had an opportunity to review a board decision to postpone a stockholder meeting in order to change the then-likely outcome of that meeting—a stockholder vote down of a merger agreement. The opinion is notable in that the Court suggested the so-called *Blasius*[87] standard of review—that when board action is taken with the "primary purpose of preventing or impeding" a stockholder vote, such action will be found invalid unless the board can show a "compelling justification" for thwarting that vote—should be reformulated. Further, the Court held that even if *Blasius* applied, the "compelling justification" test had been satisfied.

The *Blasius* standard, prior to the *Inter-Tel* decision, rarely had been applied in Delaware jurisprudence outside of the election of director context, and even within the election of director context, a finding that a board actually proved a compelling justification was virtually nonexistent.[88] In one of the few cases where the *Blasius* standard was applied outside of the election of director context, *State of Wisconsin Investment Board v. Peerless Systems Corporation*,[89] a company's CEO adjourned a stockholder meeting and left the polls open on only one of three proposals at the meeting—a proposal to increase the number of shares available to be issued under the company's stock option plan. At the time of the CEO's decision, the stockholder vote was running *against* the proposal. The Court of Chancery held the *Blasius* standard of review applicable to this fact situation, and required the defendants to show a compelling justification for their actions.[90] In contrast, in *In re MONY Group, Inc. Shareholder Litigation*,[91] the Court of Chancery declined to apply the *Blasius* standard, and instead applied the business judgment rule, to a full board's decision to postpone a meeting to vote on a merger agreement and to set a new record date for that meeting. *MONY* distinguished *Peerless* in that the full, independent board (as opposed to a CEO who, the Court presumed, was eligible for grants under the stock option plan[92]) approved the actions; further, at the time of the board's action, the stockholder vote was running *in favor* of the merger proposal (however, because approval of a merger requires the affirmative vote of an absolute majority of all voting power *outstanding*, it did not appear likely that the requisite affirmative vote would be obtained absent board action). *MONY*, attempting to conform *Peerless* with a general reluctance to apply *Blasius* outside of the election of directors context, characterized the application of *Blasius* as follows:

> When the matter to be voted on does not touch on issues of directorial control, courts will apply the exacting *Blasius* standard sparingly, and only in circumstances in which self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter and to thwart what appears to be the will of a majority of the stockholders, as in [*Peerless*].[93]

Inter-Tel adds some flesh to this skeletal case law. The facts underlying the decision are, in summary form, as follows: The independent board majority of Inter-Tel had been embroiled in conflict with the company's founder for several years regarding the future of the company. A special committee was formed to consider various alternatives, and it emerged from this tumultuous period recommending a deal in which the company would be acquired by a competitor in an all-cash merger. On the heels of the subsequent board approval of the merger agreement, the founder contacted the company's stockholders, expressing his opposition

[82] *In re Sea-Land Corp. S'holders Litig.*, 642 A.2d 792, 804 (Del. Ch. 1993), *quoted in Globis Partners, L.P. v. Plumtree Software, Inc.*, 2007 Del. Ch. LEXIS 169 (Del. Ch. Nov. 30, 2007).

[83] *Globis Partners, L.P.*, 2007 Del. Ch. LEXIS 169 at *29.

[84] *LAMPERS*, 918 A.2d at 1180 n.8.

[85] *In re The MONY Group, Inc. S'holder Litig.*, 853 A.2d 661, 675-76 (Del. Ch. 2004) (citations omitted).

[86] 929 A.2d 786 (Del. Ch. 2007).

[87] 564 A.2d 651 (Del. Ch. 1988).

[88] *See, e.g.*, Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumably There Are Circumstances In Which It Is Equitable To Take That Action: The Implicit Corollary To The Rule Of Schnell v. Chris-Craft*, 60 BUS LAW 877 (2005); William T. Allen, et al., *Function Over Form: A Reassessment Of Standards Of Review In Delaware Corporation Law*, 56 BUS LAW 1287 (2001).

[89] 2000 Del. Ch. LEXIS 170 (Dec. 4, 2000).

[90] The effect of the *Peerless* decision on a case involving a similar set of facts is discussed in *Louisiana State Employees' Retirement System v. Citrix Systems, Inc.*, 2001 Del. Ch. LEXIS 115 (Del. Ch. Sept. 17, 2001).

[91] 853 A.2d 661 (Del. Ch. 2004).

[92] *Id.* at 675 n.51.

[93] *Id.* at 674.

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to the merger and putting forth a competing leveraged recapitalization proposal. Institutional Shareholder Services and several significant stockholders opposed the merger, and it became clear that the merger would not receive stockholder approval at the upcoming stockholder meeting. Moreover, as votes were totaled in the days leading up to the meeting, it was also clear that an absolute majority would vote to oppose adjournment of the meeting.

On the day scheduled for the meeting, the special committee voted to postpone the meeting rather than convene it. Although the committee minutes listed numerous reasons for postponing the meeting, the Court's opinion strongly suggests that the primary reason for the postponement was that, had the meeting been held, the merger would have been defeated and the special committee wanted more time to convince ISS and the stockholders to support the merger.[94] After the postponement, a new meeting date and record date were set.

In the weeks prior to the rescheduled stockholder meeting, Inter-Tel downwardly revised its financial projections, ISS and several institutional stockholders changed their position in favor of the merger, and the founder withdrew his recapitalization proposal. At the rescheduled meeting, a majority of stockholders approved the merger. A stockholder plaintiff sued, seeking to enjoin the closing of the merger and an order that the merger be put up for another vote.

In its analysis of the plaintiffs' claims, including a claim that, because the stockholder vote was running against the merger, *Peerless* required an application of the *Blasius* standard, the Court suggested a reformulation of that standard. Describing the *Blasius* standard as ''too crude a tool for regular employment,'' the Court took issue with the fact that decisions in the wake of *Blasius* tended to be outcome-determinative—that is, the courts' opinions had reasoned their way to finding that disenfranchisement had not occurred, obviating the need to apply the actual *Blasius* standard.[95] Additionally, the Court noted that the strict *Blasius* standard had rarely been applied and although the stockholder franchise needed protection, such protection should be applied ''in a more workable way than *Blasius* articulated.''[96] Finally, the Court found it problematic that *Blasius* seemingly applied to all stockholder votes, including those with little bearing on whether directors would remain in office.[97] The Court then proposed a reformulated version of the *Blasius* standard:

> To be specific . . . the burden should be on the Inter-Tel board as an initial matter to identify a legitimate corporate objective served by its decision to reschedule the June 29 special meeting on the Mitel Merger and to set a new record date. As part of meeting that burden, the directors should bear the burden of persuasion to show that their motivations were proper and not selfish. That showing, however, is not sufficient to ultimately prevail. To ultimately succeed, the directors must show that their actions were reasonable in relation to their legitimate objective, and did not preclude the stockholders from exercising their right to vote or coerce them into voting a particular way. If for some reason, the fit between means and end is not reasonable, the directors would also come up short.[98]

This proposed reformulation, then, would place on a target board the burden to identify a legitimate corporate objective served, requiring a showing that the actions were (1) reasonable in relation to a legitimate objective, and (2) did not preclude the stockholders from exercising their voting rights or coerce their voting rights in any way.[99] The Court applied this reformulated standard to the actions taken by the Inter-Tel special committee. First, noting that the special committee diligently responded to and facilitated bids for the company, the Court found that, in postponing the meeting, the special committee was motivated by a good faith concern that the merger was in the best interests of the stockholders and if the meeting were held on the date originally scheduled, the benefits of the merger for the stockholders would be lost.[100] Second, the Court found that that the special committee's acts did not preclude the stockholders from rejecting the merger.[101] Third, the Court found that the stockholders were not coerced in any way by the short delay and new record date.[102]

Recognizing that such an evolution in the law as proposed by the Court has not yet been adopted by the Delaware Supreme Court, the Court of Chancery went on to apply the traditional *Blasius* test and held that, even under its exacting standard, the special committee demonstrated a compelling justification for its actions, stating:

> In the corporate context, compelling circumstances are presented when independent directors believe that: (1) stockholders are about to reject a third-party merger proposal that the independent directors believe is in their best interests; (2) information useful to the stockholders' decision-making process has not been considered adequately or not yet been publicly disclosed; and (3) if the stockholders vote no, the acquiror will walk away without making a higher bid and that the opportunity to receive the bid will be irretrievably lost.[103]

Although the vote was running against the merger (and, indeed, against a proposal to *adjourn* (as opposed to postpone) the stockholder meeting), the Court distinguished *Peerless* in that in *Peerless*, (1) the ballot was closed on all of the proposals ''except for the proposal on which it had not generated enough stockholder support''; (2) the proposal in *Peerless* could be resubmitted to stockholders, whereas an injunction in *Inter-Tel* might cause the acquiror to walk away; and (3) the ac-

[94] 929 A.2d at 797.
[95] *Id.* at 805-06.
[96] *Id.* at 806-07.
[97] *Id.* at 808-09.
[98] *Id.* at 810-11.
[99] In a 2008 case, *Portnoy v. Cryo-Cell International, Inc.*, 940 A.2d 43 (Del. Ch. 2008), the Court of Chancery discussed in further detail its vision of a reformulated *Blasius* standard. Although *Portnoy* involved an election of directors (as opposed to approval of a transaction), the case provides an interesting discussion of the interplay between the standards of review discussed in this portion of the article and Delaware law on ''vote buying.''
[100] 929 A.2d at 813. In finding that the committee acted with a proper purpose, the Court nonetheless found certain actions of the committee less than ideal. Specifically, the Court noted that the committee should have been more forthright as to why it was postponing the meeting. Additionally, although the Court expressed concern with the changed record date, ultimately, it found that the change in record date did not determine the outcome of the merger vote. *Id.* at 813, 816-17.
[101] *Id.* at 817.
[102] *Id.*
[103] *Id.* at 819.

tion in *Peerless* was "tainted by the self-interest of the CEO."[104] Even if the Court's proposed reformulation of the *Blasius* standard does not gain traction, this case remains significant in that it represents one of the few instances where the Court has applied the *Blasius* standard and found a compelling justification, further distinguishes *Peerless* and provides guidelines on how far a board may go in soliciting a yes vote on a transaction, even if the stockholder vote is running against the proposed transaction at the time of the board's action.

IV. Step Four—Soliciting in Favor of the Transaction: Disclosures

Although deal lawyers tend to focus on federal disclosure requirements in drafting proxy statements soliciting votes in favor of a transaction, it must be remembered that directors of a Delaware corporation are subject to a state law fiduciary duty of disclosure. When seeking stockholder action, "[t]he directors of a Delaware corporation are required to disclose fully and fairly all material information within the board's control."[105] In many instances, the state law disclosure duty parallels the federal law disclosure duty—indeed, the materiality standard utilized under Delaware law is the same as that utilized under federal law.[106] However, a number of opinions handed down in 2007 suggest that Delaware courts might have moved ahead of federal law in at least one discrete area of disclosure—management projections. Specifically, the Court of Chancery's opinions in *Netsmart*,[107] *In re Checkfree Corporation Shareholders Litigation*,[108] and *Globis Partners, L.P. v. Plumtree Software, Inc.*[109] each discussed whether management projections need be disclosed when soliciting a stockholder vote on a transaction.

A. Historical Case Law.

Historically, the Delaware courts did not require disclosure of management projections when seeking stockholder approval of a transaction, even when such projections formed the basis for an investment banker's fairness opinion that itself was disclosed to the stockholders. Thus, in *Skeen v. Jo-Ann Stores, Inc.*,[110] the Court rejected the plaintiffs' argument that the following information should have been disclosed to stockholders voting on a cash-out merger: "(1) a summary of 'the methodologies used and ranges of values generated by [the investment bank]' in reaching its fairness opinion; (2) management's projections of [the company's] anticipated performance from 1998-2003; (3) more current financial statements; and (4) the prices that [the company] discussed for the possible sale of some or all of the company during the year prior to the merger."[111]

Subsequently, the case law reflected a shift toward including a summary of the data and calculations used by investment banks in rendering fairness opinions. Thus, in *McMullin v. Beran*, the Court found a proxy statement in a similar situation deficient, and one of the listed deficiencies was the failure to include information that had been provided to the investment bank and information on the valuation methodologies used by that bank.[112] The Court of Chancery thereafter discussed the inconsistent holdings in *Skeen* and *McMullin* with regard to disclosure in *In re Pure Resources, Inc. Shareholders Litigation*,[113] finding that a summary of the data and methodologies used by the investment banks in rendering a fairness opinion must be disclosed:

> In my view, it is time that this ambivalence be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely. I agree that our law should not encourage needless prolixity, but that concern cannot reasonably apply to investment bankers' analyses, which usually address the most important issue to stockholders—the sufficiency of the consideration being offered to them for their shares in a merger or tender offer. Moreover, courts must be candid in acknowledging that the disclosure of the banker's "fairness opinion" alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability. The real informative value of the banker's work is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result.[114]

In 2007, the Court wrestled with whether to move beyond *Pure Resources* and require not only a summary of a banker's analyses, but also the disclosure of management projections. The *Netsmart* case pointed toward a bright-line rule requiring disclosure of management projections in a going-private transaction; however, two subsequent cases appear to step away from such a rule.

B. 2007 Developments.

In *Netsmart*, the stockholder plaintiffs raised numerous objections to the disclosures made in a proxy statement seeking approval of a merger. These included a claim that the proxy statement was materially incomplete because the board failed to disclose management projections that were relied on by its investment banker in the banker's discounted cash flow valuation used to support its fairness opinion. The projections at issue had been generated by the bank based on input from Netsmart's management, covered the years 2007-2011, and constituted the management's best estimate of the company's future cash flows.[115] The proxy statement did contain two other sets of projections, neither of which was identical to the management projections and neither of which included revenue, cost or earnings estimates for the years 2010 and 2011.

In finding the omission of these management projections material, the Court found relevant that they were

[104] *Id.* at 811 n.77.
[105] *Malone v. Brincat*, 722 A.2d 5, 12 (Del. 1998).
[106] In *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985), the Delaware Supreme Court adopted the materiality standard set forth by the United States Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), namely that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."
[107] 924 A.2d 171 (Del. Ch. 2007).
[108] 2007 Del. Ch. LEXIS 148 (Del. Ch. Nov. 1, 2007).
[109] 2007 Del. Ch. LEXIS 169 (Del. Ch. Nov. 30, 2007).
[110] 750 A.2d 1170 (Del. 2000).
[111] *Id.* at 1173.
[112] 765 A.2d 910, 925 (Del. 2000).
[113] 808 A.2d 421 (Del. Ch. 2002).
[114] *Id.* at 449.
[115] *In re Netsmart Tech., Inc. S'holders Litig.*, 924 A.2d at 202.

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the final projections used in the discounted cash flow analysis that supported the banker's fairness opinion, that the nature of the transaction was a cash-out merger, and that the company occupied a special market niche. First, the Court noted that the banker's discounted cash flow analysis covered 2007 until 2011 and was based on the management projections covering the same period of time; notably, the proxy statement contained no other financial information covering 2010 or 2011 (the latter being referred to as the ''critical, terminal year'' by the Court).[116] The Court stated:

> The conclusion that this omission is material should not be surprising. Once a board broaches a topic in its disclosures, a duty attaches to provide information that is ''materially complete and unbiased by the omission of material facts.'' For this reason, when a banker's endorsement of the fairness of a transaction is touted to shareholders, the valuation methods used to arrive at that opinion *as well as the key inputs and range of ultimate values generated by those analyses must also be fairly disclosed*. Only providing some of that information is insufficient to fulfill the duty of providing a ''fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of the [] board as to how to vote . . . rely.''[117]

Second, the Court focused on the fact that the stockholders were being cashed out in the merger, and stated that ''[f]aced with the question of whether to accept cash now in exchange for forsaking an interest in Netsmart's future cash flows, Netsmart stockholders would obviously find it important to know what management and the company's financial advisor's best estimate of those future cash flows would be.''[118]

The third fact that the Court cited in support of its finding was that the company had a unique market niche, which could cause stockholders to place greater weight on management projections than on a banker's analysis of comparable companies:

> In concluding that this omission is material, I also take into account that stockholders might place greater value on company-specific estimates of future performance in this situation than on inferences based on supposedly comparable companies. The defendants themselves have stressed Netsmart's unique market niche and its dominant position in a niche market. Therefore, the materiality of a direct evaluation of the value of the company's expected future cash flows might rationally take on more importance in this instance than comparisons to other firms or transactions several times larger or smaller or in different sectors than Netsmart.[119]

Taking these three factors into consideration, the Court ultimately enjoined the merger vote pending supplemental disclosure.

Netsmart raised concern among practitioners that Delaware law was tending toward a bright-line rule that management projections must be disclosed in a going-private transaction. However, in *In re Checkfree Corporation Shareholders Litigation*, the Court denied a motion for preliminary injunction based in part on a similar claim that management projections were not disclosed, holding that the proxy statement contained a fair summary of the banker's analysis even absent a disclosure of management projections. In *Checkfree*, Checkfree Corporation had accepted an offer to be acquired by Fiserv, Inc., and Goldman Sachs rendered an opinion that the merger was fair to the Checkfree stockholders.[120] Citing *Netsmart*, the plaintiffs claimed that because the proxy statement indicated that management prepared financial projections and that such projections were utilized by Goldman in preparing its fairness opinion, the board breached its duty to disclose by not including those projections in the proxy statement. The Court, relying on *Pure Resources*, found that the proxy statement contained a fair summary of the work done by Goldman in support of its fairness opinion even absent a disclosure of management projections.[121] The Court distinguished *Netsmart* on the grounds that in contrast to the Checkfree proxy statement, the Netsmart proxy statement did not contain a fair summary of the methods used by the banker in rendering its fairness opinion and it did include earlier versions of some of the management projections, which required further disclosure.[122] Furthermore, the Court noted that the Checkfree projections were raw and incomplete, and stated that, as such, the projections actually could be ''misleading.''[123] Based on these findings, the Court denied the plaintiffs' motion for a preliminary injunction.

The Court reached a similar conclusion in *Globis Partners, L.P. v. Plumtree Software, Inc.*[124] In that case, BAE Systems, Inc. acquired Plumtree Software, Inc., and a plaintiff challenging the transaction alleged in part that the directors breached their fiduciary duties by failing to disclose certain management projections. The Court succinctly dismissed this claim on the basis that the management projections at issue were unreliable and possibly misleading. In so holding, the Court noted that the plaintiff did not allege that the company had reliable projections, and instead only criticized the banker's determination that the management projections were unreliable and unhelpful. The Court stated that such criticisms were insufficient for a breach of the duty of disclosure claim.[125] In the course of its discussion, the Court emphasized that the duty of disclosure ''does not extend to the provision of information to per-

[116] *Id.* at 202-03.

[117] *Id.* at 203-04 (quoting *In re Pure Resources S'holders Litig.*, 808 A.2d at 448-49) (emphasis added).

[118] *Id.* at 203. *But cf. Skeen*, 750 A.2d at 1174 (rejecting a ''new disclosure standard in cases where appraisal is an option'').

[119] *Id.*

[120] 2007 Del. Ch. LEXIS 148 (Del. Ch. Nov. 1, 2007).

[121] While the Court did not provide a checklist for what must be disclosed in a summary of a banker's substantive work, the Court described the proxy statement as including the following information:

> Over the course of seven pages, the proxy statement details the various sources upon which Goldman relied in coming to its conclusions, explains some of the assumptions and calculations management made to come to its estimates, notes exactly the comparable transactions and companies Goldman used, and describes or otherwise discloses management's estimated earnings and estimated EBITDA for 2007 and 2008 and a range of earnings derived from management estimates for 2009. The proxy statement also explains that, in tandem with conveying its estimates, management discussed the particular risks it foresaw that might undercut those estimates. While there is no ''checklist'' of the sorts of things that must be disclosed relating to an investment bank fairness opinion, I conclude that the disclosure in this case satisfies the Pure Resources standard.

Id. at *9.

[122] *Id.* at *10.

[123] *Id.* at *11.

[124] 2007 Del. Ch. LEXIS 169 (Del. Ch. Nov. 30, 2007).

[125] *Id.* at *48-49.

mit stockholders to make 'an independent determination of fair value.' "[126]

Following *Checkfree* and *Plumtree*, it is not clear whether Delaware law is indeed tending toward the bright-line requirement to disclose management projections in soliciting votes in favor of a going-private transaction, as suggested by *Netsmart*. What can be gleaned from the sum of these cases is that the drafter of a proxy statement should consider disclosing management projections if (1) such projections are reliable, complete and not misleading, (2) management had disclosed earlier projections that are no longer accurate, or (3) the fairness opinion relied upon by a board or special committee in recommending the transaction was based on such projections.

Even outside of these situations, however, a 2007 settlement hearing in the Court of Chancery, which awarded a large amount of attorneys fees to the plaintiffs attorney in a disclosure-only settlement, may counsel toward erring on the side of disclosure, at least until this area of the law becomes more settled. In *Globis Partners, LP v. Safenet, Inc.*,[127] plaintiff stockholders sued Safenet, Inc. after it was announced that Vector Capital initiated a tender offer for Safenet. The lawsuit raised both disclosure and *Revlon* claims. The relevant disclosure materials (i.e., the 14d-9) only attached the fairness opinion itself, but contained no summary of the analysis underlying the fairness opinion. The parties agreed to settle pending dissemination of the banker's books, but the *Revlon* claims were dropped. The plaintiffs' attorneys sought $1.2 million in fees, and the defendants argued that such fees were too high and should instead be set at $108,000. The crux of the defendant's arguments was that the plaintiffs' lawyers should not receive fees for the work done on the *Revlon* claims that ultimately did not result in legitimate claims, and that the fee was too high for a disclosure claim alone.

The Court awarded the full $1.2 million. With regard to the *Revlon* issues, the Court found that the plaintiffs' lawyers were entitled to be compensated for the risk they took with regard to the *Revlon* claims and that the company did benefit from the raising of the claims. With regard to the disclosure claims, the Court found the fee appropriate given the "extremely bare-bone, non-informative disclosures."[128] Interestingly, the Court also suggested that some of the responsibility for the disclosure lay with the investment banks, and stated that when a target negotiates with an investment bank, it should make sure it has the ability to disclose the bankers' work:

> [M]aybe the next time people negotiate with their bankers, part of the issue with the bankers is if you are going to be an advisor and you are going be a grown-up, then you are going to participate like a grown-up in the securities markets of this country, and not put your clients in a stupid situation. . .[129]

This settlement conference is a red flag that disclosure claims can be very costly to a company, and practitioners should consider advising their clients to take into account the risk-adjusted expense of settling a disclosure claim in determining whether to disclose a full set of management projections.[130]

V. Step Five—Navigating Appraisal Rights

Once a merger has closed, if the stockholders are entitled to appraisal rights (as in a private company or cash-out merger), the surviving corporation must concern itself with issues surrounding those rights.[131] 2007 was a notable year for appraisal law in light of *Highfields Capital, Ltd. v. AXA Financial, Inc*,[132] as well as certain important changes to the appraisal statute (Section 262 of the DGCL).

The Court of Chancery's decision in *Highfields*[133] is notable because the Court departed from its usual reliance on the discounted cash flow (DCF) valuation method for appraising the value of shares following a merger. The Court suggested that, so long as an auction is run properly, the transaction value is a fair indicator of the going concern value of the company. The case is thus somewhat in tension with the previously accepted notion that fair value for appraisal purposes is not necessarily a function of market value. This case arose following the acquisition of The MONY Group, a public company, by AXA Group, wherein AXA cashed out the MONY stockholders for $31.00 per share. The MONY board decided to forgo a typical auction process in favor of a post-signing market check, during which no other bidders had emerged expressing interest in MONY besides AXA.

The Court largely discounted the valuations provided by the experts for each side, and noted that although it tended to rely on the discounted cash flow analysis in appraisal valuations, "that metric has much less utility in cases where the transaction giving rise to appraisal was an arm's-length merger, where the data inputs used in the model are not reliable, or where a DCF is not customarily used to value a company in a particular

[126] *Id.* at *39-*40 (quoting *In re Staples Inc. S'holders Litig.*, 792 A.2d 934, 954 (Del. Ch. 2001)).

[127] C.A. No. 2772-VCS (Del. Ch. Dec. 20, 2007) (oral transcript).

[128] *Id.* at 45.

[129] *Id.* at 31. The Court went on to state that the $1.2 million fee could be viewed as "the third bankers' fee, perhaps caused by the first two bankers." *Id.* at 45.

[130] The totality of the 2007 cases on disclosures may also push the market toward more detailed covenants regarding disclosure of bankers' work, such as the following from the February 20, 2008 merger agreement providing for Pfizer's acquisition of Encysive Pharmaceuticals:

> The Company also represents and warrants that (A) the Company Board has received the opinion of Morgan Stanley & Co. Incorporated (the "Company Financial Advisor"), dated the date of this Agreement, to the effect that, as of such date, and subject to the various assumptions and qualifications set forth therein, the consideration to be received by the Company's stockholders in the Offer and the Merger is fair to such holders from a financial point of view and (B) the Company has been authorized by the Company Financial Advisor to permit the inclusion of such opinion and/or references thereto in the Offer Documents and, together with a description of the material financial analyses underlying such opinion, in the Schedule 14D-9 and any Proxy Statement, subject to prior review and consent by the Company Financial Advisor (such consent not to be unreasonably withheld or delayed).

[131] 8 *Del.C.* § 262 entitles a stockholder to the right to have the fair value of its stock appraised by the Court of Chancery when the corporation is a constituent entity in a merger, subject to certain exceptions. For a more thorough discussion of Section 262, see 2 DAVID A. DREXLER, LEWIS S. BLACK, JR. & A. GILCHRIST SPARKS, III, DELAWARE CORPORATION LAW AND PRACTICE § 36 (2008).

[132] 2007 Del. Ch. LEXIS 126 (Aug. 17, 2007).

[133] *Id.*

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industry."[134] Ultimately, the Court accorded no weight to the DCF analyses provided by the experts on both sides, and also rejected the experts' comparable companies and comparable transactions valuations because the companies and transactions utilized were not truly comparable to MONY and the merger, respectively.

Instead, the Court relied on the "shared synergies" and "sum-of-the-parts" analysis in finding that the former MONY stockholders in the appraisal proceeding were entitled to $24.97 for each share of MONY, about 20% less than the cash-out price. Most notably, the shared synergies analysis relied on the merger price (less synergistic elements) in determining the fair value of the shares.[135] The Court stated that:

> [t]he . . . logical explanation for why no bidder ever emerged is self-evident: MONY was not worth more than $31 per share because no prospective purchaser, either strategic or financial, stood to gain the synergies AXA anticipated in the merger, synergies which it was willing to share with MONY's stockholders. On these facts, the transaction giving rise to this appraisal action is a solid indicator of MONY's fair value. . . .[136]

Time will tell the true impact of this case. The *potential* impact, however, is quite material in that the case signals a willingness by the Court of Chancery to entertain an argument that, so long as an arms-length transaction was the product of a proper market check, the fair value of the target corporation may be the deal value minus synergies.

With regard to the appraisal statute itself, the 2007 legislative amendments involved three substantive changes. First, the appraisal statute was amended so that a stockholder may unilaterally withdraw its demand for appraisal for a period of sixty days from the effective date of the merger, even if an appraisal action has commenced, unless the stockholder seeking to withdraw its demand either commenced an appraisal proceeding or joined such a proceeding as a named party.[137] Second, the appraisal statute was amended to allow a beneficial owner of stock who owns stock either through a voting trust or through a nominee to commence an appraisal proceeding and to request a statement setting forth the aggregate number of shares that were not voted in favor of the transaction and for which appraisal has been demanded.[138] Third, the appraisal statute now has a set default interest rate, so that unless the Court of Chancery sets a different interest rate in its discretion "for good cause shown," interest on an appraisal award will accrue and compound quarterly from the effective date of the merger through the date the judgment is paid at "5% over the Federal Reserve discount rate (including any surcharge) as established from time to time during the period between the effective date of the merger and the date of payment of the judgment."[139] Although these amendments will be relevant following a transaction, their immediate effect is to require deal lawyers to ensure that any summary of appraisal rights distributed to stockholders accurately reflects the changes to the statute.

VI. Potential Step Six–Handling a Busted Deal

Finally, 2007 served as a reminder to deal lawyers that no matter how carefully crafted, a transaction is not certain to close until the effective date is reached. As the leveraged buyout boom of 2005 to mid-2007 gave way to the current credit crunch, the public announcement of leveraged buyouts gave way to the public announcement of "busted deals"— terminated transactions (e.g., Silver Lake Partners' and ValueAct Capital's acquisition of Acxiom Corporation), amended transactions reflecting decreased consideration (e.g., Lone Star Funds' acquisition of Accredited Home Lenders, Providence Equity's acquisition of the television assets of Clear Channel) and disputes between parties to such buyouts (e.g., Thomas H. Lee Partners LP's and Bain Capital Partner LLC's acquisition of Clear Channel). The key issue seeming to underlie many of these "busted deals" had been whether or not a "Material Adverse Effect" had ocurred, such that the acquiror had a contractual right to walk away from the transaction.[140] Taking a backseat to this issue had been whether, should an acquiror not successfully prove that a Material Adverse Effect had ocurred, the target can sue the acquiror to compel the acquiror to complete the transaction (i.e., sue for specific performance of the transaction). Stated another way, are the merger agreements underlying these leveraged buyouts simply option contracts or is the acquiror obligated to complete the

[134] *Id.* at *54 (citations omitted).

[135] *Id.* at *72. The "sum-of-the-parts" approach consisted of four separate calculations: "(1) an actuarial appraisal to value MONY's life insurance and annuity business; (2) a blended comparable company and comparable transactions approach to value MONY's broker-dealer subsidiary; (3) a weighted discounted cash flow and comparable company metric to value MONY's asset management business; and (4) a standard accounting approach to value MONY's corporate assets and liabilities." *Id.* at *81.

[136] *Id.* at *75.

[137] Prior to the 2007 amendments, a stockholder's right unilaterally to withdraw an appraisal demand terminated once an appraisal proceeding was filed.

[138] 8 *Del. C.* § 262(e). Previously, these actions could only be taken by a record holder of stock. Record holders continue to be the persons obligated to take the first step in perfecting appraisal rights—delivering a demand for appraisal.

[139] 8 *Del. C.* § 262(h). In the past, the DGCL contained no default interest rate for appraisal awards.

[140] Delaware courts have held, in applying both New York and Delaware law, that a condition to closing that there be no material adverse effect is generally meant to capture a "durationally significant" weakening, as opposed to a short-term change:

> [Such clauses are] 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.

Frontier Oil Corp. v. Holly Corp., 2005 Del. Ch. LEXIS 57, at *127-*128 (Del. Ch. Apr. 29, 2005) (quoting *In re IBP Shareholders Litigation*, 789 A.2d 14, 68 (Del. Ch. 2001)). In *Genesco, Inc. v. The Finish Line, Inc.*, No. 07-2137-II(III), slip op at 35 (Tenn. Ch. Ct. Dec. 27, 2007), a Tennessee court interpreting a merger agreement governed by Tennessee law, distinguished *IBP* in stating that a "blip" in earnings (in *Genesco*, a two-month decline) may constitute a material adverse effect if the parties allow for a short-term cure period in their transaction documents, thus acknowledging "that in the context of [their] merger, a [material adverse effect] can occur in three or four months." This statement was dicta because the Court had previously held that even if a material adverse effect occurred, the drop in earnings fell within an express exception to what may constitute a material adverse effect. It is unclear whether a Delaware court would follow the logic of *Genesco*.

transaction? Complicating this question is the typical structure of private equity-led going-private transactions, in which (i) the parent private equity fund is *not* a party to the merger agreement; (ii) the acquiror party executing the merger agreement is a shell entity created by the parent private equity fund to effect the transaction; (iii) the shell entity enters into an equity commitment letter with the parent private equity fund and a debt commitment letter with banks funding the transaction, through which the shell entity will fund the transaction; and (iv) these equity and debt commitment letters often contain provisions, such as no recourse provisions and no third-party beneficiary provisions, designed to cabin the effect of any specific performance award or award of damages at the shell entity level.

In *United Rentals, Inc. v. RAM Holdings, Inc.*,[141] the Delaware Court of Chancery addressed some of the issues associated with this question. The *United Rentals* litigation arose after an entity controlled by Cerberus Capital Management, L.P. notified United Rentals, Inc. that it would not proceed with a leveraged buyout of URI by Cerberus. URI filed suit in the Court of Chancery against the two Cerberus-controlled shell entities party to the merger agreement, seeking to compel the Cerberus Entities to consummate the buyout. The relevant language in the merger agreement provided that URI ''shall be entitled to seek an injunction . . .to enforce specifically the terms and provisions of this Agreement . . . to enforce compliance with those covenants of [the Cerberus Entities] to . . . consummate the transactions contemplated by this Agreement if . . . the Financing . . . is available,'' *subject to* a separate provision in the merger agreement that ''in no event shall [URI] seek equitable relief or seek to recover any money damages in excess of [a termination fee] from'' the Cerberus Entities or other affiliates of Cerberus. The Court of Chancery found this language ''hopelessly conflicted'' and did not find the evidence presented at trial enough to yield an ''obvious, reasonable interpretation'' of the merger agreement. Thus, the Court relied on ''the forthright negotiator'' principle—i.e., that ''in cases where the extrinsic evidence does not lead to a single, commonly held understanding of a contract's meaning, a court may consider the subjective understanding of one party that has been objectively manifested and is known or should be known by the other party.''[142] Under that principle, the Court found that even if URI believed the merger agreement provided it with a specific performance right, its attorneys did not communicate that belief to the Cerberus Entities and that the attorneys to the Cerberus Entities *did* communicate to URI their belief that the merger agreement did not provide URI with the right to seek specific performance of the merger agreement, and consequently the merger agreement did not provide URI with a specific performance right.

The *United Rentals* opinion, at its core, is a contract interpretation opinion, unique to the contract language at issue before the Court. However, in addressing the details of the documents in front of it, the Court provides some guidance on the ''big picture'' issues that parties to leveraged buyouts must address.

As the Court recognized is ''market practice'' in leveraged buyouts, the buy-side parties to the merger agreement were shell entities. Thus, any attempt by URI to seek relief under the merger agreement would not be fruitful unless it could—directly by its own lawsuit or indirectly by compelling the Cerberus Entities to bring a lawsuit—reach an entity with capital. But the package of documents related to the transaction—including an equity commitment letter between one of the Cerberus Entities and Cerberus, by which Cerberus would contribute $1.5 billion of the approximate $7 billion purchase price, and a limited guarantee between URI and an entity affiliated with Cerberus relating to payment of the termination fee provided for in the merger agreement, contained language purporting to limit URI's rights against entities other than the Cerberus Entities, including the right to bring claims against Cerberus ''by or through a claim by or on behalf of'' the Cerberus Entities. URI was thus faced with the two questions many targets in ''busted deals'' find themselves asking: (1) would a claim against the ''shell'' Cerberus Entities be viewed by the Court as an indirect claim against the funds with capital barred by the terms of the ''side'' documents (here, the equity commitment letter and the guarantee) and, if not, (2) would the Court order the Cerberus Entities to seek specific performance of the terms of the ''side'' documents (i.e., the financing commitments) so that the capital necessary to close the leveraged buyout would be within URI's reach?

The Court rejected the argument that URI's lawsuit against the Cerberus Entities was a ''mere pretense'' masking URI's attempt to seek specific performance of the equity commitment letter against Cerberus, and held that the lawsuit against the Cerberus Entities, in and of itself, was not prohibited by the transaction documents.[143] This initial holding may represent a significant win for target corporations; if reputation still matters in the marketplace, the mere standing to bring suit for specific performance notwithstanding the ''by or through'' language contained in many equity commitment letters and guarantees, could provide targets with significant leverage in negotiating a settlement.

Because the Court did not find a specific performance right in the merger agreement, it did not directly address the second question; however, the Court noted the ''fundamental'' point that Cerberus ''worked mightily to limit drastically URI's ability to seek recourse against'' Cerberus, and that while ''URI may harbor dreams of compelling performance by'' Cerberus, ''that is not what they seek in this action.''[144] Thus, while the Court indicated to targets that it would not close its doors to a specific performance claim against shell entities, it left open whether practical relief would be available against the parent fund entities as a result of such a claim if the side transaction documents such as

[141] 937 A.2d 810 (Del. Ch. 2007).
[142] *Id.* at 836.

[143] *See also Clear Channel Broadcasting, Inc. v. Newport Television LLC*, C.A. No. 3550-VCS, transcript at 42 (Del. Ch. Feb. 26, 2008) (scheduling an expedited trial on the target's specific performance rights, notwithstanding the ''no recourse'' language contained in the equity commitment letters, and suggesting that even if the ''no recourse'' language prohibited a specific performance order requiring the shell entity to sue its parent in order to enforce the equity commitment letters, specific performance could be ordered in a way that would not implicate the ''no recourse'' language in those letters, such as an order to find ''club deal'' financing or to sue the lending banks in order to enforce the debt commitment letters).
[144] *United Rentals, Inc.*, 937 A.2d at 829.

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the equity commitment letters and the guarantees contain ''no recourse'' provisions.[145]

Although the Court ultimately found that the merger agreement did not provide URI with a specific performance right, the Court did so only after finding that URI's proffered interpretation of the merger agreement (i.e., that the limitation on seeking equitable relief was related only to equitable relief that allows for money damages (e.g., rescission)), while reasonable, was not the *only* reasonable interpretation, and that the Cerberus Entities' interpretation of the merger agreement (i.e., that because the right to specific performance is ''subject to'' the limitation on seeking equitable relief, it is subservient to that limitation) was also reasonable. However, twice in its post-trial opinion and once in a letter opinion denying plaintiff's motion for summary judgment, the Court remarked that whether the Cerberus Entities' interpretation was unreasonable was ''an exceedingly close question.''[146] Should the Court have come out the other way on this ''exceedingly close question,'' it would not have reached the extrinsic evidence or forthright negotiator principle and URI would have been entitled to specific performance. As the Court observed, ''parties often riddle their agreements with a certain amount of ambiguity in order to reach a compromise,''[147] and get comfortable with the availability of *ex post* interpretation, if necessary. The *United Rentals* opinion serves as a guide to drafters that settling on compromise language that may be labeled ambiguous by a court, without informing the other side of the drafter's interpretation of that language, risks a client being subject to the ''forthright negotiator'' principle should the language prove ambiguous and the extrinsic evidence unhelpful in yielding an interpretation.

Negotiators of leveraged buyouts must anticipate issues such as those addressed in the *United Rentals* opinion in drafting leveraged buyout transaction documents, and advisors to parties to such transaction documents often must work within the ''compromise language'' contained in such documents in strategizing in the event of a potential ''busted deal.'' The import of the *United Rentals* opinion does not lie in any bright-line rules for dealing with all of the issues associated with drafting, and advising on, leveraged buyouts. Rather, the import of the *United Rentals* opinion is that it provides additional, if limited, context for such negotiators and advisors, and its outcome—allowing an acquiror to walk away from a transaction—no matter how close of a question it was, may alter the dynamics of leveraged buyout negotiations, where, the Court reminds, ''the importance of reputation in the private equity field''[148] has heretofore played a central role in a transaction's construct.

VII. Conclusion

This article touched upon just a few of the issues transaction planners face in the course of a deal. Though Delaware law governing transactions developed at a significant pace during the course of 2007, practitioners must remain cognizant that, for the most part, the developments refine guidelines and do not set bright-line rules. Nevertheless, these guidelines should help practitioners advise their clients as to the framework of the Delaware corporation law.

[145] *Cf. Clear Channel Broadcasting, Inc. v. Newport Television LLC*, C.A. No. 3550-VCS, transcript at 62 (Del. Ch. Feb. 26, 2008) (expressing doubt, at a scheduling conference, whether a shell entity ''could be compelled to sue'' its parent private equity fund, when the equity commitment letter contained ''no recourse'' language).

Even in the absence of a no recourse provision, a Delaware court will not issue an order of specific performance of a contract if that court ''cannot 'effectively supervise and carry out the enforcement of the order.' '' *West Willow-Bay Court LLC v. Robino-Bay Court Plaza LLC*, 2007 Del. Ch. LEXIS 154, at *57 (Del. Ch. Nov. 2, 2007) (quoting *Bryson v. J.T.B., Inc.*, 1977 WL 23826, at *7 (Del. Ch. Aug. 15, 1977)). Targets in busted deal litigation may be concerned, then, whether a Delaware court would issue an order of specific performance requiring a shell entity to sue its lenders under a debt commitment letter containing, for example, a New York forum selection clause. *But cf. Clear Channel Broadcasting, Inc. v. Newport Television LLC*, C.A. No. 3550-VCS, transcript at 81 (Del. Ch. Feb. 26, 2008) (indicating, at a schedule conference, a potential willingness to issue such an order).

[146] *United Rentals, Inc.*, 937 A.2d at 833 n.104.

[147] *Id.* at 845.

[148] *Id.* at 843 n.185.