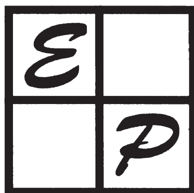

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Never Say Never, But, You May Have to Wait Two Years: Delaware's *Airgas* Decision

By Clifford Neimeth, a Shareholder of Greenberg Traurig, LLP

In *Air Products & Chemicals, Inc. v. Airgas, Inc.*, C.A. No. 5249-CC (Del. Ch. February 15, 2011), Chancellor Chandler of the Delaware Court of Chancery, upheld the unanimous decision by the directors of Airgas, Inc. to maintain in effect Airgas' poison pill[1] to block the consummation of Air Products & Chemicals, Inc's unsolicited $70 per share offer to acquire all outstanding shares of Airgas' common stock.[2] Chancellor Chandler's decision—the latest in a string of rights plan litigations decided by the Chancery Court and the Delaware Supreme Court[3] during the past year—was much anticipated because it is the latest post-trial ruling on a target board's use of the "just say no" defense in response to an unsolicited tender offer.

Background of the Case

The narrow issue presented was whether "price inadequacy" alone could justify the board's continued refusal to redeem the poison pill in the twilight of an approximately one-year takeover battle involving (i) Airgas' all-cash, fully financed, premium-priced, structurally non-coercive tender offer, (ii) the absence of a "white knight" or any alternative strategic or financial transaction sponsored by Airgas' board, and (iii) Airgas' publication of comprehensive forecast, growth strategy, cost savings plan and earnings guidance information supporting the board's view of Airgas' intrinsic value, prospects and sale value.[4] More broadly, the Chancery Court was tasked with answering whether there is a time in a corporate control contest when a target board is required to redeem a poison pill (and enable stockholders to tender their shares for purchase by a hostile bidder) because there no longer exists a legally cognizable threat justifying the continued maintenance of the rights plan.

Notably, there was no specific challenge to the reasonableness of management's assumptions for achieving Airgas' five-year projections (although the Chancery Court observed that reasonable minds could differ

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[1] Although there are technical distinctions, for ease of writing, the terms "poison pill," "rights plan" and "rights agreement" are used herein interchangeably. The use of the words "redeem" and "terminate" when referring to Airgas' poison pill is used herein somewhat colloquially and is not intended to be mechanically precise.

[2] Airgas' rights plan was adopted on May 8, 2007, Air Product's tender offer was commenced on February 11, 2010, and on February 22, 2010, Airgas' board took action to defer the "distribution date" of the rights that otherwise would have occurred ten business days after the commencement of Air Product's tender offer.

[3] See *Versata Enterprises, Inc. v. Selectica, Inc.* 5 A.3d 586 (Del. 2010); *Yucaipa American Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010); *eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473 (Del. Ch. Sept. 9, 2010).

[4] The evidentiary record and Airgas' public filings demonstrated four quarters of positive performance. The Chancery Court observed that, for a full year, Airgas' board informed stockholders as to the "opportunistic timing" of Air Product's offer during an industry down cycle and that Airgas' stockholder base was sophisticated and armed with all the information necessary to make a well-informed tender offer decision.

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as to management's optimism); Airgas (and three of Airgas' newly elected directors, collectively) engaged three, well-recognized financial advisors, each of which delivered "inadequacy opinions" to the Board throughout the course of the takeover battle (including the $70 per share price ultimately denominated by Air Products as its "best and final" offer); and (other than the *Unocal*[5] presumption of director conflict when a target company implements defensive measures in response to unsolicited offers), there were no specific allegations challenging the independence and disinterestedness of Airgas' directors. On the contrary, the Chancery Court assigned considerable weight to the fact that, just several months earlier, Air Products won a short-slate election contest to seat its three director-nominees on Airgas' classified Board and that each of them concluded that Air Product's $70 per share tender offer price was inadequate and Airgas should remain resolute in its takeover defense (and keep the poison pill in place).[6]

Ultimately, Chancellor Chandler concluded that although he personally believed Airgas' poison pill had "served its legitimate purpose," he was constrained by Delaware Supreme Court precedent to rule that pure price inadequacy (as determined by Airgas' board) constituted a legitimate threat to Airgas and that the continued use of the poison pill to thwart an inadequately priced offer was non-preclusive and non-coercive, and a reasonable response to such threat under the circumstances. Accordingly, he denied plaintiffs' request for an order to redeem Airgas' poison pill. Chancellor Chandler was careful to emphasize, however, that his ruling should not be read to suggest that a board can "just say no" indefinitely in all cases or that it can "just say never." Because Air Products withdrew its tender offer shortly after the decision was issued, there will be no appeal to the Delaware Supreme Court and the "just say no" defense (at least in this particular factual context presented to the Chancery Court) is alive and well unless and until the Delaware Supreme Court weighs in.

The Judicial Review Standard

Doctrinally, this case involved application of the (now) well-familiar *Unocal/Unitrin*[7] test to specifically determine whether: (i) after reasonable investigation and inquiry, the board in good faith determined there was a legitimate threat to Airgas' corporate policy and effectiveness, (ii) continued use of the rights plan was being used to "cram down" management's strategic or financial alternative to Air Product's hostile bid or render "realistically unattainable" a successful proxy fight by Air Products to obtain control of Airgas' classified Board and terminate Airgas' rights plan, and (iii) Airgas' continued use of the poison pill otherwise fell within a range of reasonable responses to Air Product's undervalued offer.

In view of the (oft-cited) "omnipresent specter" of self-interest inherent in director actions taken in response to an unsolicited change in control bid (*Unocal*'s presumption in such context of entrenchment motives and other influences and biases extrinsic to the corporate merits of a director's decision), for more than 25 years *Unocal/Unitrin* has been Delaware's (intermediate) judicial review standard in takeover defense cases, including rights plan maintenance/redemption cases. Accordingly, Airgas' directors had the burden to demonstrate satisfaction of the *Unocal/Unitrin* standard before being entitled to the substantive protection of the business judgment rule.

Price Inadequacy and the Threat of Substantive Coercion

The Chancery Court initially addressed (under the first prong of *Unocal*) whether Airgas' directors "articulated a legitimate threat to corporate policy and effectiveness." This entailed a process-centric analysis that required Airgas' directors to demonstrate good faith and reasonable investigation (*i.e.*, requisite due diligence). Satisfaction of the directors' evidentiary burden was materially enhanced by the fact that Airgas' board was composed of a majority of outside, independent directors, including Air Product's three newly elected nominees.

Chancellor Chandler identified three categorical "threats" that have been articulated over the years by the Delaware courts when reviewing defensive responses to takeover threats that touch upon issues of control. Namely, (i) "structural coercion," (ii) "opportunity loss" and (iii) "substantive coercion." Structural

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[5] *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[6] Air Products nominated three directors for election at Airgas' 2010 annual meeting of stockholders held in September 2010 and proposed three amendments to Airgas' by-laws to, among other things, accelerate Airgas' annual meeting cycle to January in each year. Each of Air Product's director nominees were elected, but the Delaware Supreme Court, in *Airgas, Inc. v. Air Products and Chemicals Inc.*, 8 A.3d 1182 (Del. 2010) reversed Chancellor Chandler's decision in the Chancery Court and held that, in the case of a classified (or staggered) board of directors, provisions that refer to "annual" meetings mean meetings occurring at approximately one-year intervals.

[7] *Unocal*, 493 A.2d 946 (Del. 1985); *Unitrin, Inc. v. American General Corp.*, 654 A.2d 1361 (Del. 1995).

coercion was not relevant in this case because Air Product's unsolicited bid was not a "front-end loaded" (*i.e.*, a two-tiered, partially financed, prorated) offer designed to induce stockholders into tendering their shares under the duress of receiving less valuable or uncertain second-step merger consideration. Similarly, there was no threat of opportunity loss because Airgas' board did not propose or endorse any alternative strategic or financial transaction during the takeover battle. Instead, Airgas' board was committed to executing management's five-year business plan that was adopted prior to the commencement,, and was not modified during the pendency, of Air Product's offer—a "stay the course" strategy. Therefore, there was no threat that Airgas' stockholders would be deprived "of the opportunity to select a superior alternative offered by target management." There also were no specific allegations of material disclosure misstatements or omissions that prevented Airgas' stockholders from making a voluntary tender offer decision.

The third category—"substantive coercion"—is addressed in more than [illegible] pages of the Chancery Court's 15[illegible]-page decision (considerable portions of which are dicta). Tracing the progression over the years of Chancery Court and Delaware Supreme Court rights plan cases where "substantive coercion" has been identified, interpreted and applied,[8] Chancellor Chandler observed that substantive coercion involves the risk that tendering stockholders might tender their shares into an unsolicited, undervalued offer in mistaken disbelief (or unaware) of the board's view of the target company's intrinsic value relative to the tender offer price.

Chancellor Chandler offered his personal view that price inadequacy should not, in itself, constitute a *Unocal* threat where all material information regarding the board's views of the company's true value are published (as in Airgas' Solicitation/Recommendation Statements on Schedule 14D-9 and in its periodic reports) and made known over a durationally significant period such that stockholders could make their own fully informed tender offer decision. He further noted that, in his view, substantive coercion becomes more dubious where adequate disclosure has been made over a reasonable time frame and management fails to substantively negotiate with the hostile bidder, search for a "white knight" or sponsor any alternative financial or strategic transaction. Accordingly, he suggested that there must be a time in the lifespan of a hostile bid where the deterrent purpose of a poison pill—to buy time as a protective shield for the target's stockholders—comes to an end, so that the stockholders have the exclusive ability to determine their own economic fate.[9]

With respect to Air Products' successful 2010 proxy fight and the reliability of management's five-year projections, Chancellor Chandler stated: "[T]he fact that Air Products' own three nominees fully support the rest of the Airgas board's view on value, in my opinion, makes it even less likely that stockholders will disbelieve the board and tender into an inadequate offer." Next, distinguishing the (generally) voluntary nature of an unsolicited tender offer (contrasted with a merger effected pursuant to Section 251 of the DGCL, which requires both board approval and stockholder adoption of the merger agreement), he questioned why "if stockholders are presumed competent to buy stock in the first place . . . they [are] not presumed competent to decide when to sell [their shares] in a tender offer after an adequate time for deliberation has been afforded them?"

Chancellor Chandler also observed that to the extent stockholders with long-term ownership or investment horizons need protection from short-term, event-driven investors (who, irrespective of a target's intrinsic value, nonetheless may be motivated to tender for immediate gain), such possibility should not constitute substantive coercion under the first prong of *Unocal*. To this last point, he noted the lack of any discussion in Airgas' board meeting minutes that stockholders might tender into Air Product's offer in mistaken disbelief (or in ignorance) of the board's views as to price inadequacy. Instead, he pointed to Airgas' arguments in the litigation regarding the concern that merger arbs and hedge funds would support Air Product's $70 bid price and coerce the remaining Airgas stockholders into tendering their shares and implied that these short-term investors and market speculators quite likely purchased their positions from longer-term stockholders who already decided to cash out.

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[8] See *City Capital Associates Limited Partnership v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988); *TW Services, Inc. v. SWT Acquisition Corp.*, 1989 WL 20290 (Del. Ch. March 2, 1989); *Paramount Communications, Inc. v. Time*, 571 A.2d 1140 (Del. 1990); *In re Gaylord Container Corp. Shareholders Litigation*, 753 A.2d 462 (Del. Ch. 2000); *Chesapeake v. Shore*, 771 A.2d 293 (Del. Ch. 2000).

[9] "After more than sixteen months have elapsed and one annual meeting convened with three price increases and Air Product's representatives credibly testifying ... and publicly representing that they have reached the end of the line ... this dispute has reached the end stage." *Air Products*, C.A. No. 5249-CC (Del. Ch. February 15, 2011) at 97 n. 352.

Personal views notwithstanding, Chancellor Chandler applied the law as it exists today in Delaware (as announced by the Delaware Supreme Court in *Paramount*[10] and *Unitrin*) and confirmed that price inadequacy, without more, if determined by an independent and well-informed board acting in good faith after reasonable investigation and after consultation with competent professional advisors (including, in this case, the receipt of "inadequacy opinions" from not one, not two, but three, prominent financial advisory firms), is a legally cognizable threat under *Unocal*.

Coerciveness, Preclusiveness and Proportionality

Having found the existence of a threat, the Chancery Court turned to the second prong of *Unocal/Unitrin* to address whether the board's continued use of Airgas' rights plan was "draconian" (*i.e.*, coercive or preclusive) and, if not, whether such continued use was proportionate to the threat of substantive coercion.

Because there was no alternative transaction endorsed by management (and the board's basis for "just saying no" was its belief that execution of management's five-year business plan was a better long-term bet than recommending the acceptance of $70 in cash today), there was no management coercion. Coercion in this context (not to be confused with structural coercion and substantive coercion) when determining the existence of a threat under the first prong of *Unocal* has been construed to mean a target-sponsored transaction that is being "crammed down" on the stockholders. Because Airgas repeatedly published its intention to maintain the status quo throughout the year-long takeover battle with Air Products, there was no management-sponsored alternative transaction being foisted upon Airgas' stockholders.

Next, the Chancery Court noted that to establish (in a poison pill redemption case) that the continued use of the poison pill is "preclusive," such use has to make "realistically unattainable" the bidder's ability to win an election contest. Air Products had two basic choices going forward: (i) win another short-slate proxy contest with respect to the directors up for election at Airgas' 2011 annual meeting (which would require obtaining votes from the holders of a simple majority of Airgas' outstanding common stock) or (ii) as permitted under Airgas' certificate of incorporation, solicit the holders of 33% of Airgas' common stock to call a special meeting to remove the entire Airgas board with a supermajority vote of the non-affiliate holders of 67% of Airgas' outstanding common stock (which would translate into having to obtain removal votes from the holders of almost 86% of all outstanding shares).

Informed by the Delaware Supreme Court's recent *Selectica* decision, the Chancery Court stated that a rights plan combined with a classified board is not preclusive just because two election cycles must lapse before a bidder can obtain board control and redeem the poison pill and that the financial hardship and commercial risks occasioned by such delay (tangible as they may be) are not synonymous with preclusiveness. Accordingly, after reviewing the evidentiary record (including the testimony proffered by the litigants' respective proxy advisory firm experts), Chancellor Chandler could not conclude that Airgas' poison pill prevented Air Products from having a "real world shot" at obtaining the requisite stockholder votes to change the composition of Airgas' board and redeem the poison pill—even if that meant waiting until Airgas convenes its 2011 annual meeting.[11]

Having determined that Airgas continued use of the rights plan was neither coercive nor preclusive, the Court lastly considered the "proportionality" requirement under the second prong of *Unocal* to determine whether such continued use fell within a range of reasonable defense measures employed by Airgas' board (or, in other words, whether keeping the poison pill in place and "just saying no" was a proportionate response to the threat of price inadequacy identified by Airgas' board).

Repeating aspects of his analyses in earlier portions of his opinion, Chancellor Chandler emphasized that Airgas' board was composed of a majority of outside, independent directors acting in good faith in

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[10] *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990).

[11] Chancellor Chandler explained that "realistically attainable," for purposes of *Selectica* and *Unitrin*, must be more than a "mere mathematical possibility" or a "hypothetically conceivable chance" of circumventing a poison pill:

> "One would think a sensible understanding of [realistically attainable] would be that an insurgent has a reasonably meaningful or real world shot at securing the support of enough stockholders to change the target board's composition and remove the [poison pill]. It does not mean the insurgent has a right to win or that the insurgent must have a highly probable chance or even a 50-50 chance of prevailing. But it must be more than just a theoretical possibility, given the required vote, the timing issues, the shareholder profile, the issues presented by the insurgent and the surrounding circumstances."

Air Products, C.A. No. 5256-CC (Del. Ch. February 15, 2011) at 128-129.

consultation with numerous professional advisors, and understood that Air Products' own handpicked director nominees were convinced that Air Products' $70 offer price was inadequate "by no small margin" (i.e., at least $78 per share). Citing *Paramount*, he noted that Airgas was not in *Revlon* mode, and there was no basis to conclude that management's preexisting "stay the course" strategy was unsustainable. Accordingly, Airgas' directors had no fiduciary obligation to redeem the poison pill, especially where Air Products or another bidder could seek to acquire Airgas by offering the right price at the right time in the future. Although the *raison d'être* of maintaining in effect the rights plan was for Airgas' board to retain exclusive authority regarding the outcome of Air Products's offer, such usage was reasonable under the circumstances and the Airgas directors, by just saying no, acted consistent with their fiduciary duties.

Irrespective of the policy debate regarding the proper allocation of decisional authority in a corporate control contest between directors and the stockholders who elect such directors to oversee the day-to-day business and affairs of a Delaware company, the Chancery Court clearly was duty bound to hold that if a Delaware company has not put itself in "*Revlon* mode," directors are not obliged, as a fiduciary matter, to abandon management's long-term business plan and seek to obtain maximum current value for stockholders just because the company has been put in play by a hostile suitor.

It is well-established that Delaware directors are the exclusive architects and overseers of the timetable for and methods of selling corporate control and that *Revlon's* enhanced current value maximizing obligations cannot be animated unilaterally by an unsolicited suitor.[13] There are, of course, a broad range of real-time/real world considerations that make the analysis not just a simple academic exercise but, as a general matter, the directors' business judgment (in the absence of a clear evidentiary showing of director and management bad faith, disloyalty or gross negligence) cannot be supplanted, *post hoc*, with a Delaware court's commercial point of view.

The Upshot of Airgas

The *Airgas* case is one of the most important Delaware rights plan decisions in years. It reaffirms that a poison pill, together with a classified board (where the target's directors can be removed only "for cause" (or where they can be removed "without cause" in accordance with specific anti-DGCL default provisions in the target's certificate of incorporation such as Airgas' supermajority stockholder vote requirement), indisputably is the most potent antitakeover combination that can be implemented. Of course, only the poison pill can be adopted unilaterally by directors.

Despite the trend over the last decade of Fortune 500 and S&P 500 companies to allow their rights plans to expire (whether or not with a "pill on the shelf" replacement) and to declassify their boards (both, partly in response to the significant influence of the major proxy advisory firms, such as ISS, and partly in response to direct pressure exerted on companies by activist stockholders, pension fiduciaries, hedge funds and corporate governance reformists), *Airgas* makes clear that Delaware directors have wide latitude to just say no—now or later—so long as they are well informed, act in good faith, are disinterested and independent, and rely to the extent appropriate on the advice of competent legal and financial experts and other consultants.

Some Take Aways

Process Always Matters—Establishing the Record

Chancellor Chandler noted the absence of any discussion in Airgas' board minutes of the threat of price inadequacy. It is vitally important, in any board decisional process (and certainly when considering the adoption, maintenance, amendment or redemption of a stockholder rights plan) to reflect in the minutes the core information and matters reviewed and considered by the board in the course of its deliberations. Because "preclusiveness" in a pill redemption case is interpreted under *Unocal/Unitrin* as preventing a real world shot at winning a proxy fight, the board should carefully consider, analyze and document

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

[13] See *Unitrin*, 651 A.2d at 1376 (citing *Paramount*, 571 A.2d at 1153): "[T]he directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan." Put another way, *Paramount* has long stood for the proposition that Delaware directors need not, in the face of a current value maximizing offer, abandon a well-conceived long-term business plan unless there clearly is no realistic basis to sustain the plan.

with counsel and the company's outside proxy solicitation firm the likelihood of a successful campaign to unseat a majority of the directors and redeem the poison pill. Of course, this may require two consecutive annual meetings in the case of a classified target board.

"Just Say No" is Here to Stay (and Likely for a Long While)

Only the Board can put itself in "*Revlon* mode." A hostile suitor cannot unilaterally impose on the Board an obligation to forego management's deliberately conceived long-term business strategy in favor of a control premium payable today. The *Airgas* decision, in accordance with *Unitrin* and *Paramount*, makes clear that independent and disinterested Delaware directors acting in good faith, in consultation with expert advisors, can reject an all-cash, all-shares, non-structurally coercive, fully financed and properly disclosed tender offer, solely on the basis of price inadequacy; albeit not forever and not with absolute impunity. Delaware directors are not required to transfer, and cannot abdicate, to stockholders their decisional authority under Section 141 of the DGCL.[14]

It's Up to the Delaware Supreme Court

Chancellor Chandler was duty bound to follow Delaware Supreme Court precedent despite the academic debate on whether there is a point in time when a rights plan outlives its intended purpose (*e.g.*, among others, to buy time for the board to publish all financial and other information necessary for stockholders to fully understand the intrinsic value, prospects and sale value of the target company, and to identify, study and propose, if available, *bona fide* transaction alternatives to the unsolicited offer). The question remains: Is there a scenario where a target board's continued maintenance of a rights plan ever could be deemed "preclusive" under *Unocal/Unitrin* if such maintenance is not preclusive even after the bidder successfully wages one proxy fight but must win at least two to obtain control of a classified board?

Moreover, query whether it would have made any difference if (i) Airgas experienced four consecutive quarters of poor financial and operating performance, (ii) only one financial advisor issued the "inadequacy opinions," (iii) Air Products's director-nominees believed in good faith that $70 per share was the best price reasonably attainable for Airgas or that it was a blockbuster price relative to their view of Airgas' intrinsic value and prospects, (iv) a substantial majority of Airgas' outstanding shares already had been tendered into the tender offer, (v) the poison pill was adopted in direct response to the hostile offer and not preexisting, (vi) there was evidence that Airgas' stockholder base was composed of a substantial number of long-term holders (unrealistic as that may be in the case of a year-long takeover battle), or (vii) the expert testimony of Air Products's proxy advisory firm demonstrated that the likelihood of winning a second consecutive proxy fight was more theoretical than real.

There could be a "next time" when the facts warrant redemption of a poison pill that has run its course, although, in the case of a classified board, this could require a bidder to keep its tender offer open for an unprecedented two-year period—something difficult to anticipate in the near future because the *Airgas* case already involves the longest poison pill case in history.

Proxy Fight Messaging Matters

Chancellor Chandler's decision highlights the importance of campaign platforms and fight letter messaging when waging an election contest. In its discussion of "proportionality" (*i.e.*, the second prong of *Unocal*), he specifically noted that Air Product's director-nominees campaigned on the promise that, if elected, they "would consider without any bias [Air Product's offer]" and would "be willing to be outspoken in the [Airgas] boardroom about their views." Because all three nominees were, in fact, elected at Airgas' 2010 annual meeting (which presumably included the votes of merger arbitrageurs and other event-driven investors) and Air Product's nominees "changed teams" and joined Airgas' incumbent directors in unanimously recommending the rejection of Air Products $70 offer price, this suggested to Chancellor Chandler that Airgas' stockholder base was not automatically predisposed to tendering but choosing not to do so solely because of Airgas' poison pill and not because of price. Although these are inferences, it lent further credibility to the reasonableness of the Airgas board's "just say no" defense.

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[14] See *Paramount*, 571 A.2d at 1154 (Del. 1990) ("The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders.") See also *Dollar Thrifty Shareholder Litigation*, 2010 WL 3503471 at 29 (Del. Ch. September 8, 2010) ("[Delaware] law does not require a well-motivated board to simply sell the company whenever a high market premium is available.").

How Process Flaws Can Rewrite Your Merger Agreement: Misconduct, Remedies and *Del Monte*

By A. Thompson Bayliss and Matthew Davis of Abrams & Bayliss LLP

On February 14th, the Delaware Court of Chancery issued a groundbreaking preliminary injunction decision in *In re Del Monte Foods Company Shareholders Litigation*, C.A. No. 6027-VCL. The opinion concludes with an order (i) enjoining the stockholder vote on a proposed merger between Del Monte and an affiliate of a buyout group led by Kohlberg Kravis Roberts & Co ("KKR") for twenty days and (ii) enjoining the operation of the merger agreement's no-shop, matching right and termination fee provisions for that twenty-day period. The factual predicate for the Court's decision, including the process flaws described in the opinion, are eye-catching. But the legal implications of the opinion are more important. As discussed below, the *Del Monte* decision signals a new willingness on the part of the Court of Chancery to remedy fiduciary misconduct with a time-limited injunction precluding the operation of otherwise valid and enforceable merger agreement provisions.

Factual Background of the *Del Monte* Opinion

The preliminary record presented in connection with the stockholder plaintiff's injunction application describes a behind-the-scenes effort by Barclays Capital, Del Monte's financial advisor, to stir up interest in Del Monte and then secure its spot (and significant fees) as the sell-side financial advisor and a buy-side lender. Based on the preliminary record, the Court determined that the stockholder plaintiff was likely to prove at trial that:

- Barclays planned all along to secure a role providing buy-side financing in any transaction involving Del Monte.
- After securing its role as the sell-side financial advisor, and without disclosing its desire to provide buy-side financing, Barclays advised Del Monte to conduct a targeted sale process directed towards private equity firms that would likely require buy-side financing.
- Barclays facilitated a joint bid for Del Monte by KKR and Vestar Capital Partners despite knowing that both KKR and Vestar were parties to standstill agreements prohibiting joint bidding without the consent of the Del Monte board.
- After facilitating the joint bid in violation of the standstill agreements, Barclays worked with KKR and Vestar to conceal Vestar's participation from Del Monte until the company signaled that it was likely to proceed with the KKR bid. Then KKR "formally" asked for and received permission to include Vestar in the buyout group without making any concession to Del Monte.
- Barclays requested permission to provide buy-side financing to the buyout group before KKR and Del Monte agreed on price. Barclays' buy-side role ultimately forced Del Monte to pay a second investment bank $3 million to render a fairness opinion.
- After securing permission to provide buy-side financing, Barclays negotiated with KKR on the board's behalf (despite its buy-side role) and at one point reported to the Del Monte board that KKR would consider paying $18.50 when Barclays knew that KKR had received authority to bid up to $19 per share.
- Del Monte charged Barclays with running the forty-five day go-shop process contemplated by the merger agreement despite the conflict posed by Barclays' potential to earn $21 to $24 million serving as a source of buy-side financing if the KKR transaction closed.
- Barclays complained to KKR when Goldman Sachs threatened to steal the role of managing the go-shop process, and KKR "solved the problem" by letting Goldman Sachs participate in the acquisition financing.

Despite these process flaws, Del Monte ultimately secured a merger agreement with the buyout group pursuant to which Del Monte shareholders received $19 per share in cash. That price was higher than Del Monte's common stock had ever traded prior to the Court's decision and represented a 40% premium over the average closing price of Del Monte's common stock for the three-month period ending on November 8, 2010. The merger agreement provided for a forty-five day post-signing go-shop period and a termination fee representing 1.13% of total deal value (1.5% of equity value) if Del Monte terminated

based on a bidder who made a proposal during the go-shop, and a termination fee representing [illegible] of total deal value ([illegible] of equity value) if Del Monte terminated the merger agreement to enter into a transaction with another party.

The Court's Legal Analysis

In analyzing the stockholders plaintiff's request for a preliminary injunction, the Court applied the familiar legal standard, which requires stockholder plaintiffs to demonstrate (i) a reasonable probability of success on the merits, (ii) that they will suffer irreparable injury if an injunction is not granted, and (iii) that the balance of the equities favors the issuance of an injunction.

Likelihood of Success on the Merits

Vice Chancellor Laster determined that the stockholder plaintiff had established a reasonable likelihood of success on its *Revlon* claims against the Del Monte directors. The Court indicated that the plaintiff was reasonably likely to prove at trial that the directors breached their fiduciary duties by: (i) agreeing to allow KKR and Vestar to submit a joint bid and thereby giving "up [Del Monte's] best prospect for price competition without making any effort to obtain a benefit for Del Monte and its stockholders," (ii) acceding to Barclays' request to provide buy-side financing without asking whether their participation was necessary to the buyout group, and (iii) delegating the go-shop process to Barclays, despite the bank's substantial monetary interest in ensuring that the KKR bid prevailed.

The Court also determined that the stockholder plaintiff had established a reasonable likelihood of success on its aiding and abetting claims against the buyout group. The Court found that the plaintiff was reasonably likely to prove at trial that (i) KKR knew it was bound by the standstill provisions, nevertheless agreed to a joint bid with Vestar and then worked with Barclays to keep Vestar's participation hidden until an opportune time, and (ii) KKR knowingly participated in Barclays' buy-side conflict and then "squared things away" with Goldman Sachs after it threatened to [illegible] the role of running the go-shop.

Irreparable Harm and Balance of the Equities

The Court found that the plaintiff had established the necessary threat of irreparable harm based on the unique nature of the sale opportunity and the difficulty of crafting an accurate post-closing damages award. The Court found that the balance of the equities favored granting an injunction that would (i) delay the stockholder vote for twenty days and (ii) set aside the merger agreement's no-shop, termination fee and matching right provisions during that period.

The Court reasoned that its chosen remedy would not threaten consummation of the transaction because the injunction would lift twenty days from the date of the opinion and more than two months prior to the merger agreement's drop-dead date. Concern for the buyout group's contractual rights did not alter this analysis. The Court reasoned that KKR was not an innocent party and likely knowingly participated in a breach of fiduciary duty. Moreover, KKR's contractual expectations were not so settled that it would be unfair to provide injunctive relief, particularly given the substantial policy concerns at stake.

Take Aways from *Del Monte*

1. The *Del Monte* opinion identifies a new remedial path for courts assessing fiduciary misconduct that may have tainted an auction process. Previous decisions from the Court of Chancery have enjoined defensive measures, but those decisions typically resulted from actions challenging the defensive measures themselves. The *Del Monte* opinion signals that the Court of Chancery will in some instances grant relief against *permissible* deal protection measures (that the court would sustain in an arms' length deal untainted by self-interest) in order to remedy other process flaws.

2. The *Del Monte* opinion grants injunctive relief that, as a practical matter, appeared to constitute final relief. If another bidder had jumped into the fray, Del Monte terminated the merger agreement with KKR and the injunction were later determined to have been granted in error, it is unclear how the Court could have restored the no-shop or the buyout group's match rights. In prior cases, the Court of Chancery has declined to order this type of relief unless the moving party satisfied the summary judgment standard or proved its case at trial. *See, e.g., In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1022-23 (Del. Ch. June 24, 2005) ("I need not and do not reach their argument that this court should either strike down those [deal protection] provisions altogether or blue-pencil them back to reasonable limits, all before a trial has even been held. To grant that sort of mandatory relief

would, in my view, be inappropriate on disputed facts, and plaintiffs who seek such relief should move promptly, not for a preliminary injunction hearing, but for an expedited trial."). Interestingly, the Court chose a groundbreaking remedy while at the same time observing the negligible chance of any topping bid during the twenty-day delay. As the topping bid arose, if the stockholder plaintiff pursues its damages case to trial, the defendants may argue that the absence of competing bids during the court-ordered market check period demonstrates the adequacy of the deal price.

3. The *Del Monte* opinion is a stark reminder that process flaws can lead to injunctive relief, despite the absence of live disclosure claims or competing bids. The Court of Chancery has traditionally been reluctant to enjoin a fully informed electorate from electing to accept the benefits of a premium transaction, even if process flaws may have marred the sales effort.

4. The *Del Monte* opinion underscores the fact that the board of directors is ultimately responsible for process flaws, even when a third-party advisor is primarily responsible for the problems. Corporate boards must provide "serious oversight" to ensure that they do not receive tainted advice or guidance from their advisors. This oversight obligation likely includes asking tough questions to ferret out actual and potential conflicts of interest before and during the transaction process.

5. The opinion highlights the Court of Chancery's continued concern about the potential for participation on the buy-side of a transaction to influence the independence of sell-side financial advisors. This concern likely extends to stapled financing arrangements which may in some instances create a direct conflict for the sell side financial advisor.

6. Although Barclays receives the brunt of the Court's criticism, it is unclear whether the stockholders have a direct remedy against the bank for its apparent disloyalty (other than aiding and abetting claims that require the stockholders to demonstrate knowing participation in an underlying breach of fiduciary duty). Claims against Barclays for disloyalty to Del Monte are likely derivative claims that will be restricted by the demand requirement and Barclays' engagement letter with the company. Moreover, Del Monte stockholders have likely lost standing to pursue those derivative claims now that the merger has closed.

   Perhaps keenly aware of the issues related to derivative claims, on February 18, 2011, the stockholder plaintiff amended the consolidated complaint and added direct claims against Barclays for aiding and abetting breaches of fiduciary duty and tortious interference with the confidentiality agreements between Del Monte and each of KKR and Vestar. The stockholder plaintiff's tortious interference claim is premised on the theory that plaintiff and the class are third-party beneficiaries under the confidentiality agreements, which were put in place to preserve the integrity of the sale process. The plaintiff alleges that Barclays' interference with the confidentiality agreements "resulted in a manipulated sale process that prevented Plaintiff and the Class from receiving the maximum value for their shares."

7. In its irreparable harm analysis, the Court notes that "[a]bsent an injunction, the Del Monte stockholders will be deprived 'forever of the only opportunity to receive a pre-vote topping bid in a process free of taint from Barclays' improper activities.'" This reasoning could be read to apply whenever process flaws impact a sales process. If so, it is not entirely clear when damages will be an appropriate remedy for process defects, even when the litigants can invoke the Court of Chancery's fair price analysis in post-closing litigation.

8. The Court suggests that defenses to claims for money damages, including exculpation under 8 *Del. C.* § 102(b)(7), support the conclusion that plaintiff demonstrated a risk of irreparable harm. However, it is not entirely clear why the existence of an exculpatory charter provision adopted by the stockholders should somehow generate irreparable harm. If the stockholders have waived their right to recover money damages against the directors, why should they be able to claim that they face irreparable harm based on the absence of money damages claims?

9. The Court's acknowledgment of the likely applicability of 102(b)(7) and its emphasis on the viability of money damages claims for aiding and abetting underscores the fact that 102(b)(7) eliminates a damages remedy against exculpated directors without eliminating the underlying breach of fiduciary duty required to demonstrate aiding and abetting. Particularly where the likely liability regime involves joint and several liability, the operation of 102(b)(7) could shift most of the risk of an adverse judgment to aiders and abettors. Aiders and abettors may in turn attempt to shift any judgment back to exculpated fiduciaries by asserting contribution claims. It is not clear whether Delaware courts would look through the contribution claims to the underlying breach of fiduciary duty claims and continue

or exculpate the directors or view the [illegible] claims as separate and distinct claims unprotected by 102(b)(7).

10. The *Del Monte* opinion raises an interesting question about the importance of termination rights based on court-ordered injunctions. The merger agreement at issue conditioned each party's obligation to close on the absence of a court order "*that is in effect* and restrains, enjoins or otherwise prohibits *consummation* of the merger." (Emphasis added). The court-ordered injunction failed to prevent the satisfaction of that condition to closing and therefore failed to trigger a walk-away right on the part of the buyout group that might have altered the balance of the equities analysis. It is unclear whether a broader condition allowing termination would have yielded a different result, or whether the Court of Chancery would have simply enjoined the operation of that provision to preserve its remedial power.

11. The Court of Chancery rejected the defendants' request for a bond in excess of $1 billion (representing the aggregate transaction premium over Del Monte's unaffected market price). Instead, Vice Chancellor Laster found that the enjoined $120 million termination fee was the "starting point for pricing the risk of a wrongful injunction" and that bond should be set at 1% of that figure ($1.2 million) based on (i) the remote possibility of a wrongful injunction and a topping bid and (ii) the need to balance "the socially-beneficial and wealth enhancing efforts of responsible plaintiffs' counsel to remedy and deter breaches of fiduciary duty" against the "problem of over-incentivizing deal litigation by giving entrepreneurial law firms a free option to enjoin transactions."

12. The Court of Chancery discounted four affidavits submitted by the defendants which the Court characterized as "lawyer-drafted submissions" which "sought to replace the witnesses' sworn deposition testimony with a revised and frequently contradictory version." The Court pointedly observed that if "the differing averments [had] been elicited by defense counsel during deposition, as they readily could have been, the plaintiffs' counsel could have tested the witnesses through cross-examination." This guidance suggests that, all else equal, litigants may be better off asking questions of their own witnesses at their depositions to establish a record that will be afforded more weight at the preliminary injunction stage of the case.

Tips for PE Firms Participating in Stalking Horse Auctions

By Neil Whoriskey, a partner at Cleary Gottlieb Steen & Hamilton LLP

Being the stalking horse bidder in a bankruptcy auction confers a number of important benefits on the bidder, including the ability to shape the deal that will be bid against in the auction. This means that the stalking horse can set the mark for what assets will be included in the deal, what liabilities will be excluded, the contract assumption/rejection regime, the regime on cure costs, what the (sometimes all-important) transition services agreement will cover and for how long, etc. The stalking horse bidder may be able to commence antitrust and other regulatory filings before other bidders, potentially clearing critical closing conditions prior to competition with other bidders at the bankruptcy auction. The stalking horse bidder has the opportunity to get a head-start on meeting with future employees and obtaining their help in better understanding the business. Subject to antitrust concerns, a stalking horse bidder will also have an opportunity to develop relationships with nervous customers and provide them credible assurances about the future of the business being acquired. A stalking horse bidder, unlike other bidders, will be entitled to receive a breakup fee (and often expenses) if it is outbid at the bankruptcy auction. In short, there are plenty of reasons for a serious bidder to seek stalking horse status. The following provides some suggestions on how a private equity bidder can maximize its chances of becoming the stalking horse.

1. Play Up Your Strengths to Seller and the Creditors Committee

Believe it or not, there are some significant advantages that PE firms enjoy over strategic bidders.

- Strategic bidders are very often competitors with the bankrupt entity. This sometimes creates an initial trust deficit, with Sellers and the creditors committee having to consider whether the stra-

[illegible]

- In addition to being able to potentially get a jump on the diligence and negotiation phase of the deal, PE firms can sometimes also sell their ability to close faster and with more certainty. Speed and certainty are critically important to the creditor's committee, for the obvious reason that the sooner they sell the target business, the more quickly creditors can get paid and stop funding a money losing business. If the strategic bidders in the auction bring with them significant antitrust risk, or fail to provide sufficiently strong assurances regarding the risk—whether in the form of a "hell or high water" covenant or a high reverse break fee—they will be at a disadvantage to a PE firm buyer that has no business overlap and is willing to provide seller with these strong assurances.

- [illegible]

2. Protect Your Achilles Heel(s)

- [illegible]

- Financing issues constitute the most important subset of the remedies question, and are always an issue for PE firms participating in auctions. How tight is the commitment? Is closing of the financing a closing condition? What are the remedies for a failure of financing? Unlike a solvent seller, with bankrupt sellers there is much less optimism that the business can eventually be re-sold after a failed closing, and the prospect of increased costs for maintaining the business until it can be re-marketed and sold can be particularly daunting. Accordingly, a financing closing condition

[1] The structural issues that are present in every PE acquisition will be present in the bankruptcy setting as well—*e.g.,* using a special purpose vehicle as the acquisition vehicle will lead to the usual tussle over whether there should be a limited but direct guarantee by the PE fund itself of all of the obligation undertaken by the acquisition vehicle, or whether a third-party beneficiary right under the equity commitment letter will suffice.

is unlikely to be acceptable, and, as noted above, there will be significant pushback from the creditors committee if the remedy for a failed financing is simply a 3 percent reverse break fee.

If a PE bidder finds itself in a position where a financing contingency is becoming a fatal flaw in its bid, there is one last hope—turning to the creditors committee for financing. It is not unheard of for creditors committees to agree to allow the debtor to take back a note from the business being sold. While the note may be discounted to some extent (and the creditors committee will no doubt tell the PE bidder that the note is being very heavily discounted) and while negotiating the terms of the seller financing is another complexity, a note may be acceptable, especially in cases where the note can be made to be marketable in a short period of time after closing (marketability will depend on the availability of proper financial statements, among other factors). In any event, if the creditors committee is unwilling to accept a financing contingency, offering to take seller financing as a back-up source of financing may help to bridge the gap.

- Due diligence is one critical area where strategic bidders can have a significant advantage over PE firms. The strategic bidders may have an excellent understanding of the operational challenges facing the target, how its supply chain works, how its sales force works, what production facilities are up to date, whether the fine print in its sales contracts are favorable, whether a long term supply contract is an off-market burden, what the environmental sensitivities are, etc. before they even have their first management meeting. Occasionally, as in any process, this can lead to problems as functional teams from each area of the strategic bidder drive their area as if it were the only one that mattered. But in general, the strategics are in a better position to move quickly to understand the business and what it is worth. What is different in the bankruptcy context is the tremendous upheaval that a bankrupt company is experiencing, often resulting in a situation where key employees with critical knowledge may have left the business either before or after the filing, where records may not be easily accessed, where the workforce may be distracted, and where any desire to fix systems is gone. Given these difficulties, and the likelihood that there will be no meaningful indemnity, due diligence of a bankrupt company is both more difficult and more important than is typically the case. As a result, PE firms generally will have to resolve to commit the resources necessary to understand the business as well as it can be understood as quickly as possible. There are no magic bullets, though a PE firm that is likely to keep a lot of jobs and that is respectful to employees that are in difficult positions may as a practical matter get more cooperation than a competitor who is likely to cut jobs or to be less than diplomatic with respect to any failings or faults in the business practices of the target.

3. Pick Your Battles

As noted, creditors are generally in something of a hurry to get what cash they can from any anticipated sale. This is of course particularly true when the business is operating at a loss, and the creditors see the liquidation value of the business being reduced on a daily basis by the costs of on-going operations. Most creditors committees are staffed by professionals with a good deal of experience in bankruptcy auctions, and they know what they want, even if the bankrupt company is having trouble figuring out what it wants. In order to avoid having a second round of negotiations with creditors when the stalking horse agreement is submitted to the bankruptcy court for approval, bidders should first of all use their best efforts to be sure that the creditors committee(s) are organized and reviewing each draft of the stalking horse agreement in close coordination with seller's counsel. Bidders should also keep in mind the following:

- Indemnities. Unless there are special circumstances, don't spend a lot of time looking for an indemnity, escrow or holdback. Creditors are likely to be somewhat less familiar with any particular business being sold than is a diligent buyer that has done its diligence, and are likely to deduct a very significant portion (if not all) of the amount of any holdback or escrow from the purchase price in reviewing bids. If the stalking horse competition is at all robust, then having even a limited holdback or escrow can be a significant detriment to your bid. That said, if there is a particular problem, or an area where diligence is simply not available given the state of the company, a very focused indemnity for a limited period and limited amount may be acceptable to the seller and the creditors committee(s). Nevertheless, a bidder may be better off pricing it into the bid than, in effect, asking the creditors to do it.

- Representations and Warranties. As there will likely not be a general indemnity for a breach of the representations and warranties, and as the bring down condition will very often be qualified by a MAC standard, the main purpose of the representations will be to supplement and test the bidder's due diligence efforts. This is far from a trivial objective, especially in cases where the diligence process has been unsatisfactory—which, as noted above, is not infrequent. However, if diligence has been more or less satisfactory, spending a lot of time lowering thresholds in the representations and expanding their coverage to areas of concern that are marginal to the business being acquired will not be productive. While the creditors will be less sensitive to this point, an unnecessarily heavy markup of the representations can make the sellers cringe, thinking of the time their diminished staff will have to devote to preparing the requisite disclosure schedules.

- Assumption of Contracts. The ability to assume or reject contracts is a key benefit of a 363 sale in bankruptcy. In any scenario, bidders will want to be certain that they are not required to assume customer contracts or supply contracts that provide unfavorable pricing or other key terms. Sellers will want to assure themselves that the bankrupt estate will not have to bear significant rejection costs. In general these two goals are not incompatible.

  Consider a company with only one customer contract, which provides the customer with the right to purchase 100 widgets for $100. If the market price of 100 widgets is $200, the bidder saves $100 in refusing to assume this customer contract, but the seller will incur a prepetition claim of $100 in rejecting such contract. However, seller's estate will only have to pay out to the rejecting customer a fraction of the $100 in damages—the fraction being the same fraction all unsecured creditors receive in respect of their pre-petition claims. Let us assume that the fraction is 50%. If buyer were willing to pay $5,000 for the business with the contract, then he should be willing to pay up to $5,100 for the business without the contract. If seller were willing to sell the business for $5,000 with the contract, then they should also be willing to sell the business for $5,050 without the contract. Buyer and seller should accordingly be able to happily settle on a price anywhere between $5,050 and $5,100. This arbitrage is key to creating value for the bankrupt estate.

  Life, however, is not ever so simple. In addition to the technical difficulties of determining whether all of a business's material contracts really are unfavorable from a pricing point of view, there are any number of other important contract terms that may color a buyer's views as to the desirability of assuming such contract, including payment, warranty, indemnity, damages waivers and other terms that a buyer may not wish to extend to customers. Additionally, there may be customers that a buyer no longer wishes to service, either because the bidder plans to shut down operations in the region where the customer is, or because there are long term service or warranty obligation that will be expensive or simply of unknown cost. On the other hand, seller may want to force the assumption of all of the customer contracts in circumstances where leaving a customer without warranty, service and ongoing software upgrades would result in large rejection damages. When these terms come into play, the scope of the arbitrage available to buyers and sellers in a bankruptcy sale may be reduced.

- Cure Costs. Cure costs are closely related to the ability to assume or reject contracts. Deals typically cut on cure costs include the following varieties: (i) buyer pays up to x amount in cure costs, with seller—who may have delivered a schedule of estimated cure costs—taking the risk of cure costs exceeding that amount, (ii) buyer and seller split all cure costs 50/50—pure risk sharing and (iii) buyer pays all cure costs for supply contracts, while seller pays cure costs associated with customer contracts. The theory behind this last variety is that buyer can build its own supply chain, and cause seller to reject supply contracts that buyer does not need, or with respect to which buyer can get a better deal elsewhere, while on the customer side, assuming that seller has continued to deliver product, cure costs will be minimal while the cost of rejecting a customer contract may be significant, especially in cases where there are extended warranty and service commitments. Which deal a bidder strikes will depend upon how certain the cure costs are when it signs the agreement, and whether there are advantages that will accrue to one or more of the bidders if it has the ability to rebuild the supply chain to its own liking.

- Bid Procedures. The key topics covered in this order include (i) the amount of the break-up fee and expense reimbursement, (ii) the cure cost regime and assumption and assignment procedures, (iii) the sale hearing date, and (iv) the procedural rules governing the auction. All of these are important topics, but it seems that occasionally an inordinate amount of time is spent searching for tactical advantages in crafting the rules governing the auction (including on topics such as the amount of the "overbid" (i.e., the minimum amount that another bidder must bid over the aggregate of the amount bid by the stalking horse plus the amount of the break-up fee and expense reimbursement), how to define "qualified bidders" that may participate in the auction, timing of bids, who gets to review bids and auction procedures for selecting the highest bid). [illegible] note that the bid procedures order needs to be approved by the bankruptcy court, and since these topics come up in every bankruptcy auction, the courts have over time established fairly well defined parameters regarding what they will or will not accept with respect to each of these topics. Time spent by the bidder tailoring its requests in this area to fit within these parameters will avoid wasting time trying to convince the debtor, then the creditors committee and finally the bankruptcy court to accept off-market terms.

- Defining scope of business and assumed liabilities. This is a battle of course in every asset deal, with the difference that in the bankruptcy context there may be a greater ability to leave behind with the estate certain pre-petition liabilities that would in the normal course be assumed with the acquired business outside of the bankruptcy context. As in the contract assumption context, it can be cheaper for the estate's creditors to have their claims diluted by a liability left behind than to suffer a reduction in the purchase price resulting from the business being sold with the liability.

- Transition Services. If the bidder is buying just part of the bankrupt company and will require transition services, it should not take for granted that those services will be available. There is a cost to the estate of continuing to provide these services when it would otherwise have wound up the estate, so questions regarding the scope, quality and term of these services should be addressed early in the process.

The Validity of Stockholders' Representatives after *Aveta*

David Schulman, Tony Chan, and Jordan McKay of Dechert LLP

Although it is common practice to appoint a stockholders' representative to facilitate post-closing matters under merger agreements governed by Delaware law, there had been little definitive guidance and accordingly, some uncertainty amongst practitioners, as to whether and to what extent these arrangements were enforceable and binding upon all stockholders. On September 20, 2010, the Delaware Court of Chancery, in *Aveta Inc. v. Cavallieri*, C.A. No. 5074-VCL (Del.Ch.), addressed this uncertainty in holding that a contractual mechanism for determining the amount of merger consideration, including the appointment of a stockholders' representative under the merger agreement to resolve issues relating to merger consideration with respect to post-closing purchase price adjustments, was authorized under the Delaware General Corporation Law as a fact ascertainable outside of the agreement as well as binding upon the minority stockholders, regardless of agency law.

Notwithstanding the broad holding in *Aveta*, there are limits to the authority delegatable to a stockholders' representative and M&A practitioners should be careful not to exceed those limitations. Additionally, even when within the ambit of the authority contemplated under *Aveta*, practitioners should ensure that the provisions providing for the grant of authority to the stockholders' representative comply with requirements of the DGCL as interpreted by *Aveta* and other cases.

Background

In 2006, Aveta Inc., a Delaware corporation ("Aveta"), acquired Preferred Medicare Choice Inc., a Puerto Rico corporation ("PMC"), which operated a provider network of doctors and other health professionals in Puerto Rico. Prior to the acquisition, PMC had two classes of shares outstanding: Class A shares, which comprised 51% of PMC's issued and outstanding stock and were owned by a group of four individuals (the "Class A Stockholders"), and Class B shares, which comprised the remaining 49% of PMC's outstanding shares and were owned by over 100 individuals (the "Class B Stockholders").

The transaction was voted on and approved solely by the Class A Stockholders, each of whom were also signatories to the Agreement and Plan of Merger and Stock Purchase (the "Merger Agreement"), while none of the Class B Shareholders signed the Merger Agreement or were entitled to vote on the transaction. Pursuant to the Merger Agreement, the transaction transpired over several steps: Aveta first purchased all of the Class A shares from the Class A Stockholders for 60.93% of the total merger consideration, which included a $157 million cash payment at closing, and then a newly-formed Puerto Rico acquisition subsidiary of Aveta merged into PMC, with PMC surviving. As a result of the merger, the Class B Stockholders were entitled to receive the remaining 39.07% of the total merger consideration.

The Merger Agreement contemplated potential earn-out payments during a [illegible] year period after closing, as well as post-closing adjustments to the merger consideration to reflect working capital and claims experience for liabilities incurred but not recorded at closing. The Merger Agreement also provided for the appointment of a stockholders' representative, Robert Bengoa, to resolve issues relating to the various post-closing purchase price adjustments and specified mechanisms for calculating these amounts and resolving any disputes relating thereto. After the transaction closed, and after nearly a year of unsuccessful negotiations between Aveta and Bengoa regarding the post-closing adjustments, Aveta and Bengoa [illegible] Ernst & Young [illegible] would be final and binding, all in compliance with the provisions set forth in the Merger Agreement regarding disputes between the parties, after which Aveta attempted to arbitrate with Bengoa, while Bengoa refused to proceed with the arbitration.

During this period, former Class A and B PMC stockholders attempted to revoke Bengoa's designation as stockholders' representative, claiming that he lacked the authority to represent them. In response, Aveta filed suit in the Delaware Court of Chancery against the former PMC seeking to resolve the question as to "whether the contractual process for calculating the consideration, including the outcome of the [Ernst & Young] arbitration, binds all former PMC stockholders."

Aveta

Class A Stockholders. Addressing the ability of the former stockholders to revoke Bengoa's authority, the court first held as a matter of agency law that the Class A Stockholders, as signatories to the Merger Agreement, were bound by Bengoa's actions because they irrevocably appointed Bengoa as their agent under the Merger Agreement.

Choice of Law. Although the merger agreement provided that it would be governed by Delaware law, under the internal affairs doctrine the court determined that the law of Puerto Rico governed the internal corporate mechanics of the merger (including the conversion of Class B shares) since the two corporations party to the merger were incorporated in Puerto Rico. Accordingly, the court applied Section 10.51 of the General Corporation Law of 1995 of the Commonwealth of Puerto Rico (the "PRGCL"), which parallels Section 251 of the DGCL as it existed in 1995. Both Sections provided that "any of the terms *of the agreement of merger or consolidation may depend upon facts ascertainable outside of such agreement, provided that the manner in which such facts shall affect the terms of the agreement is clearly and expressly set forth in the agreement of merger or consolidation.*"

Class B Stockholders. After an analysis of the legislative history of both statutes and relevant case law, the court determined that the Class B Stockholders were bound under the relevant provisions of corporate law since the post-closing adjustments easily qualified as provisions dependent on "facts ascertainable outside of the merger agreement." In making this determination, the Court noted that "facts" included

"determinations and actions of a designated person or body" including Bengoa as the stockholders' representative and Ernst & Young as arbiter. In reaching its holding, the Court noted that while post-closing adjustment turned on financial figures derived from financial statements, the formulas for deriving those amounts were "clearly and expressly" set forth in the Merger Agreement. Accordingly, although Class B Stockholders were not signatories to the merger agreement and had not entered into an agency relationship with Bengoa, the court held that Puerto Rico, and Delaware, corporate law dictated that they were still bound by the terms of the merger agreement, including the post-closing adjustment provisions.

After *Aveta* and the Limits of Delegatable Authority

In a number of cases leading up to *Aveta*, the Delaware Court of Chancery recognized that a merger agreement could authorize a stockholders' representative to act on behalf of the stockholders in certain circumstances. For example, in *Ballenger v. Applied Digital Solutions, Inc.*, the court noted that the merger agreement could confer authority with respect to certain matters on stockholders' representatives in reaching its holding where three stockholders' representatives sued to enforce an acquirer's contractual obligation to make post-closing earn-out payments. 2002 WL 749162, at *10 (Del. Ch. Apr. 24, 2002).

Subsequently, in *Coughlin v. [illegible]*, the court determined that a stockholders' representative had standing to pursue an action for breach of contingent payment rights under a merger agreement on behalf of the stockholders, without their involvement, based on provisions in the merger agreement specifically authorizing the same but in doing so, noted that the provision regarding the authority of the stockholders' representative to bind the stockholders did not need to be exhaustive. 2010 WL [illegible], at 2 (Del. Ch. Apr. 15, 2010).

Aveta, taken together with *Coughlin*, and *Ballenger*, provides M&A practitioners substantially more certainty as to whether provisions in a merger agreement appointing a stockholders' representative and providing for the determination of post-closing adjustments based on facts ascertainable outside of the agreement will be binding on minority shareholders who neither sign the agreement nor vote on the transaction.

While *Aveta* held that a stockholders' representative may be validly appointed pursuant to a merger agreement to act on behalf of all stockholders, including those not party to the merger agreement, there are limits regarding the scope of authority that may be delegated to stockholders' representatives and M&A practitioners need to take care to not exceed these limits when drafting such provisions. In *Aveta*, the court noted that the merger considerations delegated to a stockholders' representative should not be "impermissibly vague" or "constitute an improper abdication, or otherwise give rise to a breach of fiduciary duty," instead looking favorably upon the fact that the merger agreement established a clear formula and procedure "[that] must be followed." The *Aveta* Court cites additional examples where the delegation exceeded the limits allowed under Delaware law, including *Nagy v. Bistricer*, 770 A.2d 43 (Del. Ch. 2009), which held that the merger agreement could not broadly cede the determination of the merger price to the acquirer of the company, and *Jackson v. Turnbull*, 1994 WL 174668 (Del. Ch. Feb. 8, 1994), which held that the merger agreement could delegate to an individual unfettered discretion to determine the merger consideration.

Given the breadth of the decision in *Aveta*, it is likely that subsequent cases will further refine its contours with regards to the scope of authority that may be delegated to a stockholders' representative. Until then, *Aveta*, taken together with other cases discussed herein, presents an instructive framework for practitioners. Although these requirements arguably establish a low threshold, M&A practitioners should ensure that the proposed provisions remain within the limits described in *Aveta* and its predecessors.

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