Will Your Defensive Line Be Too Strong? Designing M&A Defensive Strategies

In the Omnicare opinion, the Delaware Supreme Court seemingly changed the rules surrounding the use of defensive strategies in merger agreements in order to reduce their potency. The most shocking modification was that a board’s good faith decision to agree to defensive devices would be subject to judicial review with the benefit of hindsight. Thankfully, the Delaware Chancery Court in two subsequent opinions offered clarity on the rules regarding the use of defensive devices and appears to have limited some of the harm and confusion triggered by Omnicare.

by Mark J. Kelson and David M. Grinberg

Following the Delaware Supreme Court’s decision in Omnicare, Inc. v. NCS Healthcare, Inc., defensive devices in merger and acquisition (M&A) transactions suffered a setback, and the rules under which M&A defenses operated became somewhat unclear. However, the Delaware Chancery Court’s subsequent decisions in Orman v. Cullman and In Re Toys “R” Us, Inc. Shareholder Litigation provide some clarity on the rules regarding the use of defensive devices after Omnicare. They also provide guidance regarding when companies employing a defensive strategy to protect a transaction will be penalized for violation of fiduciary duties. More importantly, however, the decisions seem to have limited the damage produced by Omnicare.

The Defensive “Players”

Companies use various defensive devices in merger agreements, such as “no-shop” and “force-the-vote” provisions, termination fees and the absence of fiduciary-out provisions, to deter third parties from attempting to interfere with the ability of parties to consummate merger transactions. (Editor’s Note: See box on p.5 for a description of these devices.) The terms “defensive devices” and “deal protection devices” are often used interchangeably to describe a measure or combination of measures intended to protect the ability of parties to ensure the transaction occurs.

Defensive devices are not always contained within the “four corners” of the merger agreement. For instance, buyers often require significant stockholders of targets to sign separate voting agreements, requiring these stockholders to vote in favor of the proposed transaction. When combined with a “force-the-vote” provision and the absence of a fiduciary-out
clause, voting agreements with majority stockholders enable the constituent parties to design a defense impenetrable to even the best offensive measures, unless, as the Omnicare case demonstrates, the Delaware judiciary flexes its muscle.

**Omnicare and the New “Rules of the Game”**

In Omnicare the merger agreement between NCS Healthcare, Inc. (NCS) and Genesis Health Ventures, Inc. (Genesis) included a “force-the-vote” provision together with voting agreements between Genesis and two NCS stockholders owning approximately 65 percent of NCS common stock. In addition, the transaction added a third prong to its defensive strategy: the absence of any effective fiduciary-out clause in the merger agreement.

Together, the three defensive devices produced a very aggressive defensive scheme that guaranteed NCS stockholder approval of the transaction. Any “change of heart” by the NCS board of directors with respect to the Genesis offer would have had no practical effect because the defensive strategies employed by Genesis and NCS made it mathematically certain that the merger would be approved by the NCS stockholders. Even if the NCS board of directors withdrew its recommendation because it received a superior proposal from a third party, the board would still be forced to submit the merger agreement to a stockholder vote and, as a result of the voting agreements, the outcome of the stockholder vote would be a foregone conclusion.

After the NCS board approved the merger, Omnicare made a superior offer. The NCS board exercised its fiduciary duties and recommended that the NCS stockholders vote against the merger with Genesis. Nevertheless, if the stockholder vote occurred, the merger would be approved. Omnicare sued for a preliminary injunction to halt the merger between Genesis and NCS.

The Delaware Supreme Court, in a 3 to 2 decision, concluded that the merger agreement and the voting agreements were invalid and unenforceable because the agreements, acting in concert, were inconsistent with the NCS directors’ fiduciary duties. Employing a balance-of-power argument, the Court determined that the defensive mechanisms used to defend the NCS/Genesis merger and ensure its consummation were subject to enhanced scrutiny under a Unocal standard of review, even though the merger did not result in a change of control. The Court acknowledged the concept in Delaware law that stockholder approval of a merger transaction is necessary to maintain a balance of power between boards of directors and stockholders. Therefore, Delaware corporate law provides that the board’s decision to enter into and recommend a merger transaction can become final only when affirmed by a stockholder vote. Defensive devices in a merger agreement had the potential to infringe on the right of stockholders to have the final statement on a transaction by preventing the stockholders from rejecting the proposed transaction and thereby shifting the balance of power in favor of the board. As a result, the Court held that Unocal applied.

The Unocal analysis is a two-step test:

1. The board must demonstrate that it had reasonable grounds to believe that not adopting the defensive devices would result in a danger to corporate policy and effectiveness; and
2. The board must show that the defensive devices were neither coercive nor preclusive and were within a range of reasonableness to the danger it identified.

The Court determined that the NCS board had reasonable grounds for believing that a danger to corporate policy existed because if NCS had not promptly executed an agreement with Genesis on Genesis’ specific terms, then Genesis would have withdrawn the offer and NCS would have been left with no comparable alternative transaction. However, the Court also concluded that the deal protection devices, operating in concert with each other, were coercive and preclusive because they made it mathematically impossible and realistically unattainable for the Omnicare transaction or any other third-party proposal to succeed, no matter how superior the subsequent offer.

Furthermore, the Court stated that the defensive measures that protected the merger transaction were also unenforceable because
they operated in such a way as to prevent the board from discharging its fiduciary duties to the minority stockholders in the face of the Omnicare transaction because of their failure to negotiate an effective fiduciary-out.  

**Omnicare Erodes Defensive Devices**

Commentators agree that *Omnicare* is a noteworthy case because the majority appeared to depart from Delaware’s business judgment rule that defers to the actions of well-informed boards of directors acting in good faith. Critics of *Omnicare*, most notably the dissent, claimed that the decision created a new “rule of the game” under Delaware M&A law. The dissent characterized this new rule as follows: “A merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up stockholder approval and does not contain a fiduciary-out provision, is per se invalid when a later significant topping bid emerges.” In addition, by stressing the unique aspects of the case, the *Omnicare* dissent seemed to suggest that the holding should be limited to its facts and not have a great deal of application in the future.

M&A professionals screamed that the “new rule” would take away a seller’s ability to trade deal certainty for a higher price and could have a deterrent effect on merger activity, because the “universe of potential bidders who could reasonably be expected to benefit stockholders could shrink or disappear.” Deal certainty itself does contain and enhance value for the target and its stockholders. First, a buyer may pay a higher price for the target if the buyer is guaranteed that the merger will close. Second, certainty prevents the target from losing its buyer and perhaps creating a perception that the target was damaged goods, which undoubtedly would reduce the value that the stockholders would receive in a subsequent transaction. Third, in exchange for deal certainty, buyers often agree to limit their own “outs” that would prevent consummation of the deal. As a result, limiting the target’s ability to agree to lock up a deal prevents certainty, which could cause a reduction in stockholder value, not an increase in stockholder value.

The issue in *Omnicare* did not involve the general validity of either stockholder voting agreements or the authority of directors to insert a “force-the-vote” provision in a merger agreement. However, these two devices, when combined with the absence of a fiduciary-out clause in the merger agreement, operated in such a fashion as to completely lock up and make it a mathematical certainty that the merger would be approved. The Court’s analysis therefore focused on the defensive devices acting in concert with each other, rather than the fact that each device in isolation was otherwise legal. As a result, two individual defensive devices that otherwise could be properly used and were legally recognized by Delaware law to deter a third-party bid, when combined, could not limit the board from continuing to carry out its fiduciary duties.

Because the board has a continuing obligation to discharge its fiduciary duties, the Court determined that the NCS board of directors violated its fiduciary duties. However, the Court erred in its conclusion because an examination of the specific circumstances that existed during the NCS/Genesis negotiations reveals that the NCS board of directors did in fact meet its fiduciary duties. First, the NCS board executed an agreement for a company that had serious financial difficulties and was on the verge of bankruptcy. The agreement with Genesis would have permitted NCS’s creditors to be paid in full with a small amount to be left over to the stockholders. Second, NCS signed the merger agreement with Genesis only after a lengthy and exhaustive search process, which included vigorous negotiations. Third, because no other bid had emerged at the time of the execution of the merger agreement, it was not unreasonable for the NCS board to believe that if an agreement were not signed with Genesis, then NCS would not be able to sign an agreement with anyone, forcing the company into bankruptcy. Fourth, the NCS board had good reason to believe that the Genesis offer would vanish if it did not agree to Genesis’ terms, including its demands regarding the defensive devices, because Genesis had issued a one-day ultimatum to accept the merger agreement with the conditions or their offer would be revoked. Fifth, the proposal submitted by Omnicare after the fact included a due diligence condition that
undercut the otherwise financially superior offer. Finally, Omnicare wanted to buy NCS at a fire sale price through an asset sale in bankruptcy, which would not have paid the creditors in full and would have left nothing for the stockholders.

In determining that the defensive devices were invalid, it is apparent that the majority evaluated the reasonableness of the decision of the NCS board to execute a merger agreement containing the defensive measures in isolation without considering the unique circumstances and conditions surrounding the Genesis/NCS negotiations and the dire situation of NCS itself. The dissent noted that the defensive lockup should not be reviewed in a vacuum. Indeed, lockups should be evaluated in the context of the entire bidding and negotiation process to determine whether the board informed themselves of all available actions and whether the board acted in good faith in accordance with its fiduciary duties. As the dissent noted, “ Situations will arise where business realities demand a lock-up so that wealth-enhancing transactions may go forward.” Given NCS’s financially dismal state and the fact that it teetered on the verge of bankruptcy, NCS was arguably in such a situation.

The Court believed that a board’s latitude in using defensive devices to protect a merger it approved varied according to the degree of benefit or detriment to the stockholders’ interests that is presented by the value or terms of the subsequent competing transaction. The practical difficulty of this type of balancing test is obvious. How could a board of directors know, at the time it adopted defensive devices, the terms of a potential competing transaction that only emerges at a later date? The balancing test would allow a court to play the role of a “Monday-morning quarterback” through the potential “judicial invalidation of negotiated contractual provisions based on the advantages of hindsight.” A board’s good faith decision must be subject to a real-time review and not a review in light of post-decision events that were unforeseeable.

Whether the Court should have applied Unocal in its analysis is an issue that is often overlooked in analyzing the Omnicare decision. The Court believed that a board’s decision to protect its decision to enter into a merger agreement with defensive devices to deter competing transactions is analogous to a board’s decision to adopt defensive measures in a hostile takeover contest. Are these two situations really similar? Unocal is used in the hostile transaction contest because boards often adopt defensive measures, such as the poison pill, to entrench themselves and because often these unilateral board actions are defensive and reactive in nature.

However, in Omnicare, the “hostile” offer did not arise until after the execution of the merger agreement. Therefore, the board’s decision to lock up the Genesis/NCS deal could not have been defensive and reactive. To the NCS board, the threat was not one of a competing offer from another company, but rather the threat was losing the only deal offered to them at that time, a deal which would satisfy the creditors in full, cure the company’s insolvency and provide some consideration for the stockholders. NCS’s board did not adopt the provisions to fend off a hostile attack. Quite the opposite, they adopted the defensive strategy because Genesis would not agree to sign the merger agreement without these provisions. As a result, the Court’s belief that Unocal was the correct standard of review was misguided.

Defensive Planning after Omnicare

After the Omnicare decision, lawyers attempting to protect transactions needed to be more conservative in planning and executing their defensive strategies. It also undoubtedly emboldened target boards of directors to refuse “force-the-vote” provisions when a significant proportion of the votes were irrecoverably committed to the transactions. Furthermore, the Omnicare case created uncertainty as to the precise level at which defensive strategies could be used. Consider the following scenarios.

A buyer and target sign a merger agreement that includes a fiduciary-out provision and does not contain a “force-the-vote” provision. In addition, holders of a majority of the voting stock of the target have signed voting agreements that
Prevalent Defensive Devices

(Provided by Mark J. Kelson and David M. Grinberg)

**No-Shop Provision.** A “no-shop” provision prohibits a target’s board of directors from soliciting or encouraging bids from third parties after the execution of the merger agreement. The provision often commits the target’s board to use its best efforts to secure stockholder approval of the transaction. However, a “no-shop” provision can often be a double-edged sword. The provision is sometimes frowned upon because of the perception that it could potentially prevent the target’s stockholders from receiving the best available price. On the other hand, a number of buyers will not proceed without a “no shop” provision fearing that the target would use its offer as leverage to find a superior deal. As a result, the target’s board of directors may be faced with losing a substantial premium if it does not agree to the “no shop” provision. If the board refuses to approve a transaction due to the inclusion of a “no shop” provision in the deal terms, then the board may have breached its fiduciary duties to its stockholders.

**Absence of a Fiduciary Out.** The unfavorable consequences to the target’s board resulting from a “no-shop” provision can often be mitigated by adding a fiduciary-out clause that restricts the “no-shop” if the fiduciary duties of the target’s board require the board to negotiate with other potential buyers and terminate the original agreement. For example, if the third party’s offer is superior to the original one. In the absence of such a fiduciary-out provision, the target’s board is unable to consider subsequent offers, even those with significant premiums to the original proposal.

**Break-Up/Termination Fees.** Break-up fees are designed to reimburse the buyer for all of its expenses related to the cost of preparing and making the offer if another bidder usurps the deal. Because parties do not want to discourage buyers from researching and making bids, they protect buyers with break-up fee provisions that allow them to recoup these costs if they end up not acquiring the seller. These arrangements usually include an additional payment above and beyond the expenses, representing lost time and opportunity. Termination fees must not be so large that they substantially discourage other bidders or make it financially impossible for the target to terminate the deal. Break-up fees are likely to be upheld provided they are not excessive and are reasonably necessary to attract the potential buyer and keep it interested in the face of competing bids.

**“Force-the-Vote” Provision.** Under Section 251(c) of the Delaware General Corporation Law, a merger agreement may contain a provision requiring the target’s board of directors to put the merger agreement to a vote of stockholders, even if the board changes its recommendation for the merger agreement, including a full withdrawal of its recommendation.

**Voting Lockup.** Buyers often seek voting commitments from significant stockholders of the target. The most common form of a voting lockup is a voting agreement requiring a significant stockholder or group of significant stockholders to vote in favor of the transaction, notwithstanding any change in or withdrawal of the target board’s recommendation. The voting agreement can also contain a provision whereby the stockholders agree to vote against any alternative acquisition proposal for a certain period of time following the termination of the merger agreement.

**Matching Rights.** Buyers frequently request a provision in the merger agreement whereby the target grants the buyer the right to match, within a small number of days, any superior offer that is received by the target.
require them to vote in favor of the transaction. As a result, if the stockholder meeting is held, the merger will, as a mathematical certainty, receive stockholder approval. Even though there would be mathematical certainty if the stockholder vote actually occurred, there would be no certainty that the meeting itself would take place, because prior to the stockholder vote, the board could exercise its fiduciary duties, terminate the merger agreement and enter into a new agreement that contained a superior proposal. Nevertheless, because the board has the ability to exercise its fiduciary duties through the fiduciary-out provision and the absence of a “force-the-vote” provision, such defensive mechanisms would probably not be viewed as coercive or preclusive. A mathematical certainty test is confusing because the timing of the certainty test is in question: overall or at the stockholder meeting.

A defensive scheme in a merger agreement consists of a “force-the-vote” provision, no fiduciary-out clause and voting agreements that obligate holders of less than a majority of the voting shares to vote in favor of the deal. Locking up 49 percent of the stockholders is not automatically preclusive because there is always the possibility, no matter how slight, that the other 51 percent vote to reject the transaction if a superior offer surfaced prior to the stockholder vote. Nevertheless, having 49 percent of the vote guaranteed prior to the actual vote, even though not a mathematical certainty would almost certainly ensure that the merger would be approved. It would not be an immense extension for a court to apply Omnicare’s reasoning to situations that included a lockup of something approaching (but still less than) a majority of the stockholder vote. If a 49 percent lockup was in fact coercive and preclusive because it was too close to mathematical certainty or was realistically unattainable, then the question remains: At what percentage would a lockup not be coercive and preclusive? In other words, what lockup percentage would deprive the target’s stockholders of a real opportunity to influence the outcome of the vote?

What about a slight modification to the foregoing. Assuming a 40 percent lockup together with a “force-the-vote” provision would not be preclusive under a given set of facts, a 60 percent stockholder entered into a voting agreement, but only committed to vote the portion of his shares representing 40 percent of the total vote. Obviously, having only 40 percent of the vote locked up would not provide mathematical certainty, but it would be safe to assume that the majority stockholder would vote his other shares in favor of the transaction, even though he was not contractually bound to do so. This type of arrangement seems a bit like form over substance.

Would the Court have ruled differently if NCS’s certificate of incorporation permitted shareholders to act in writing and the controlling shareholders had actually signed written consents sufficient to effect the merger without any subsequent solicitations, rather than just committing to vote in favor of the merger? In this situation, because the stockholders voted by way of a written consent, the board’s fiduciary duties would have ended at the execution of the written consents. Therefore, there would be no reason to have a provision in the merger agreement that maintained the board’s ability to exercise its fiduciary duties.

**Orman v. Cullman**

Consider the scenario in which a target board retains the ability to entertain an unsolicited acquisition proposal and to withdraw its recommendation of the transaction to accept a superior proposal but did not possess a termination right? In addition, the merger agreement contained a “force-the-vote” provision, and the majority stockholders entered into voting agreements and agreed to vote their shares against any alternative acquisition proposal for a period of 18 months following the termination of the merger agreement. This exact set of facts arose in Orman, the first case to apply the Omnicare holding to any significant degree.

Swedish Match AB agreed to acquire General Cigar Holdings, Inc., a company controlled by members of the Cullman family. Pursuant to a voting agreement, the Cullman family agreed that they would vote their shares in favor of the merger and against any alternative acquisition proposal.
for a period of 18 months following a termination of the merger agreement.

The merger agreement (1) permitted the board of directors of General Cigar to entertain unsolicited acquisition proposals from potential acquirors if the board concluded that such proposals would be more favorable to the public shareholders than Swedish Match’s proposal, (2) permitted the board to withdraw recommendation of the merger if it concluded that its fiduciary duties so required and (3) required that the merger could not occur without the approval of a majority of the minority public shareholders. However, the merger agreement did contain a “force-the-vote” provision and did not permit the board to terminate the agreement to accept a superior proposal.

Alleging that the General Cigar board breached its fiduciary duties because the defensive mechanism coerced the public shareholders to vote in favor of the merger, a minority stockholder sued.

As the Supreme Court did in *Omnicare*, the Delaware Chancery Court applied the two-step *Unocal* analysis to determine the legality of the defensive devices. The board easily satisfied *Unocal*’s first prong because the board had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed.”20 The reasonable grounds included the fact that during the negotiations of the merger agreement, Swedish Match had communicated the requirement that the agreement contain a defensive mechanism. As a result, had the General Cigar board not approved the defensive devices, there was a significant risk that the merger agreement would not have been executed, and in light of the fact that there were no comparable alternative transactions open to General Cigar at the time, General Cigar’s stockholders would not have received the merger premium.

In addition, the court believed that the application of the second stage of the *Unocal* analysis was “straightforward.”21 The Court set forth two reasons that the defensive measures were not coercive and did not have the effect of causing the stockholder to vote in favor of the merger for a reason other than the merits of the merger. First, the Court stated that the deal protection mechanisms were an integral part of the proposed transaction.22 Second, the Court recognized that the deal defenses did not amount to a mathematical certainty that the merger would be approved because the public shareholders were free to reject the proposed transaction through the majority of the minority voting provision in the merger agreement. Therefore, General Cigar’s fiduciary-out was significant and meaningful because the board had the ability to recommend that the stockholders reject the transactions and the stockholders had the real power to act upon the board’s recommendation and actually reject the merger.

In its conclusion, the Court declared that the plaintiff’s argument that *Omnicare* applied was misplaced, because the facts and circumstances in *Orman* differed from those in *Omnicare*, mainly in that the defensive scheme employed did not make it mathematically certain that the transaction would be approved. In other words, a change of heart by the General Cigar board could have had a meaningful result because of the board’s fiduciary-out and a majority of the nonaffiliated public shareholders having been able to reject the deal on its merits.

An interesting and somewhat troubling aspect of the decision in *Cullman* is the Court’s conclusion that the 18-month lockup was reasonable and not coercive given the absence of other deal defenses and given the buyer’s understandable concern about transaction costs and market uncertainties.23 The Court also concluded that the existence of the 18-month lockup did not coerce the minority stockholders to vote in favor of the transaction for reasons unrelated to the merits of the transaction.24

To substantiate its point, the Court contrasted the lockup with a situation in which fiduciaries threatened stockholders to vote in favor of the transaction.25 Therefore, fiduciaries cannot threaten stockholders so as to cause the vote to turn on factors extrinsic to the merits of the transaction. Isn’t an 18-month lockup that prohibits the majority stockholders from voting in favor of another transaction a form of a threat? In other words,
isn’t the implicit message from Swedish Match and the majority stockholders to the minority public stockholders essentially the following: “You have the right to reject the present transaction through a majority of the minority approval requirement, but if you do not approve the merger, the company will not be able to consider another transaction for at least a year-and-a-half because the majority stockholders are locked-up until the end of that period of time.” Because of the majority of the minority approval requirement, the defensive devices did not preclude another deal, but the 18-month lockup certainly may have made the defensive strategy coercive.

The Court downplayed the potential consequences of the 18-month lockup because there was no other bidder at the time of the execution of the merger agreement. Further, the Court believed that if a third party emerged for General Cigar, the company could let the deadline pass and enter into another transaction at that point. Is this really a practical alternative in the fast-paced M&A landscape? An 18-month postponement could certainly cause a company that might otherwise become a potential third-party bidder to quickly lose interest in a possible transaction. An 18-month period can be a substantial amount of time in the corporate life cycle, especially for a company in the tobacco business.

Furthermore, the Court’s assumption that an 18-month delay would not be a significant cost that could have coerced the stockholders to vote in favor of the deal even if a stockholder considered the intrinsic value of General Cigar to be greater than that offered by the Swedish Match transaction is not necessarily valid. How did the Court know that the stockholders were only influenced, and not coerced, by the 18-month lockup and that they were truly “free” to reject the transaction? The Court stated that nothing in the record suggested that the lockup had the effect of causing General Cigar’s stockholders to vote in favor of the transaction for some reason other than the merits of the transaction. Of course, nothing in the record suggested the opposite either.

Further problematic is that the Court did not address whether an 18-month lockup would always be permissible and, if not, under what circumstances such a lockup would be coercive. M&A professionals are then left without a clear delineation of the length and limitations that lockups can involve such that they would not be considered coercive and under what set of facts they are permissible.

**The Rules after Orman**

In both Omnicare and Orman, the courts determined that the defensive devices met the first of the Unocal standard, namely that the target’s board had reasonable grounds for believing that a danger to corporate policy existed. The first part of the analysis appears to be a relatively easy standard to satisfy. Both courts found that a risk of losing the transaction and being left with no comparable alternative transaction was sufficient to satisfy the test. Therefore, if during the merger negotiations the buyer indicates that it “requires” or “demands” defensive devices as condition to execution of the merger agreement, then the target board will be deemed to have had reasonable grounds for believing that a danger to corporate policy existed. In the course of negotiations, most buyers ask for various types of defensive devices in the merger agreement to protect against transaction costs and market uncertainties. Therefore, the court’s ruling will seemingly always turn on whether the defensive mechanisms were coercive or preclusive.

Furthermore, the determination of whether there is in fact a competing alternative transaction available to the target is a subjective one. What is considered a “competing” transaction? How similar must the terms of the alternative transaction be to the primary transaction? Furthermore, when would a transaction be considered available to the target? Must the target have received a term sheet or letter of intent from the other potential buyer or would multiple meetings and negotiations suffice?

One of the key differences between Orman and Omnicare is the fact that the defensive strategy used by in the NCS/Genesis merger resulted in stockholder approval of the merger being mathematically certain. The Court in Orman distinguished Omnicare by the fact that the defensive devices in its case did not render stockholder approval a certainty. One can
therefore imply that defensive devices are acceptable in transactions with a company that has majority stockholders, but the defensive scheme cannot go so far as to completely guarantee stockholder approval of the transaction.

The *Orman* decision also seems to suggest that the target’s board does not always have to retain the power to terminate the merger agreement itself if the minority stockholders have the right to reject the merger upon advice from the board.

In addition, *Orman* is the first case in Delaware addressing the length of lockups that prohibit votes in favor or alternative transactions. As a result, some experts argue that the case provides at least some comfort that a lockup period of 18 months will not be deemed unreasonable per se. Nevertheless, the decision does not offer a great deal of guidance for the analysis of the reasonableness of specific defensive devices, nor did the Court compare the relative coerciveness of various possible alternative deal protection strategies.

Another interesting aspect of the Court’s decision in *Orman* is the conclusion that the board of directors of General Cigar had a meaningful fiduciary-out clause. The fiduciary-out provisions in the two merger agreements were essentially the same, because each allowed the board to change or withdraw its recommendation and neither allowed the board to terminate the merger agreement nor pursue or accept a competing bid. Therefore, the true fiduciary-out in *Orman* was not the fiduciary-out clause and, in fact, had little to do with the board itself. Rather, the fiduciary-out was the ability of the minority stockholders to reject the deal whether or not the board recommended it or withdrew its recommendation.

**In Re Toys “R” Us Shareholder Litigation**

In *Toys “R” Us*, the Delaware Chancery Court further restricted *Omnicare’s* scope and application by concluding that a board’s decision to include defensive devices in a merger agreement should be evaluated on a real-time basis and in light of the circumstances and conditions that existed at the time of the decision.

Toys “R” Us agreed to a merger with an acquisition vehicle formed by a group led by Kohlberg Kravis Roberts & Co. (KKR) pursuant to which Toys “R” Us stockholders would receive $26.75 per share, a 123 percent premium over the stock price at the commencement of its publicly-announced search for strategic alternatives. The merger agreement contained four defensive devices: (1) a termination fee of $247.5 million payable by Toys “R” Us if it terminated the merger agreement to sign up another deal within a year; (2) Toys “R” Us agreed to pay up to $30 million in documented expenses after a “naked no vote;” (3) a no-shop provision that precluded Toys “R” Us from continuing to shop itself but permitted the consideration of unsolicited bids; and (4) KKR having the right to match a superior offer within three business days.

Shortly before the Toys “R” Us stockholder vote, certain stockholders of Toys “R” Us sued to enjoin the vote alleging that the board of directors breached its *Revlon* duties for several reasons, including its agreement to deal protection measures that precluded the emergence of a superior bid. Even though the plaintiffs admitted that the Toys “R” Us board did retain some flexibility to consider a higher offer from a third-party, they argued that the “cumulative effect of the termination fee and the matching rights created an unreasonably large bidding advantage for KKR that dissuaded any other bidder from presenting a topping offer.”

Following an exhaustive factual analysis, which included an extensive review of the expert opinions in the case, the Court concluded that the board’s decision to agree to the defensive devices was reasonable. The Court confessed that its ruling did not imply that the defensive strategy used in the KKR/Toys “R” Us merger agreement would not prevent a bidder who wanted to “top [the KKR Group’s bid] by a relatively insubstantial amount that would not have been substantially more beneficial to [the Company’s] stockholders, but to call such an insubstantial obstacle ‘draconian’ is inconsistent with the very definition of the term.”

The Court admitted that defensive devices in merger agreements do provide a bidding cushion
for merger partners that makes small, margin topping bids nonviable. Nevertheless, the Court believed that if the board was well-informed, the cushion resulted from a good faith negotiation process in which the target reasonably granted the protective provisions in order to obtain a good result for the stockholders. While a serious bidder who wanted to present a materially higher bid could still do so, there would be no grounds for judicial intrusion. The Court pointed to several important facts that influenced its decision, including: (1) Toys “R” Us had undertaken a publicly-disclosed 14-month strategic review; (2) the 123 percent premium over the $12.00 per share price that existed at the time the strategic process was publicly announced; (3) KKR’s bid was approximately $350 million higher than the second-highest bid and exceeded the top range of the sum-of-the-parts valuation presented to the board; (4) the break-up fee had been reduced during the negotiation process; and (5) the sale price was at the top of the range of all of the investment banker’s valuation methodologies. The Court pointed to several important facts that influenced its decision, including: (1) Toys “R” Us had undertaken a publicly-disclosed 14-month strategic review; (2) the 123 percent premium over the $12.00 per share price that existed at the time the strategic process was publicly announced; (3) KKR’s bid was approximately $350 million higher than the second-highest bid and exceeded the top range of the sum-of-the-parts valuation presented to the board; (4) the break-up fee had been reduced during the negotiation process; and (5) the sale price was at the top of the range of all of the investment banker’s valuation methodologies.

**Toys “R” Us Restores Reasonableness and Real-Time Review**

Most M&A professionals agree that the Court’s decision in *Toys “R” Us* was neither groundbreaking nor astonishing. Nevertheless, the ruling contains some important insights and messages concerning the state of deal protection devices in a post-*Omnicare* world.

In its statement, “the court must attempt, as far as possible, to view the question from the perspective of the directors themselves, taking into account the real world risks and prospects confronting them when they agreed to the deal protections,” the Court endorses *Orman’s* conclusion that a board’s good faith decision should be subject to a real-time review, while rejecting *Omnicare’s* ruling that allows the judiciary to assess the board’s actions with the assistance and advantages of hindsight. The key phrase, “when they agreed to the deal protections” all but invalidates the role of the “Monday morning quarterback.” The Court is concerned about whether the board acted reasonably based on the circumstances then facing it rather than in light of post-decision events that were unforeseeable. Had the *Omnicare* court applied this philosophy, it is fairly safe to assume that Genesis/NCS merger would have become a reality.

The Court also acknowledged that when examining the inclusion of deal protection strategies in a merger agreement, the inquiry should examine whether the board had a reasonable basis to accede to the buyer’s demand of defensive devices in the merger agreement. This principle is contrary to the Delaware Supreme Court’s conclusion in *Omnicare*, which automatically invalidated any deal protection strategy that completely locked up the deal and made stockholder approval a mathematical certainty, notwithstanding the existence of specific and unique circumstances and conditions. Applying this notion to *Omnicare*, the NCS board’s decision to completely lock up a transaction with Genesis given its severe financial distress, the lack of an alternative competing offer, Genesis’ demand of specific defensive devices, and the stringent conditions that NCS realized would accompany an offer from Omnicare, should be viewed not only as reasonable, but also in the best interests of stockholders.

In addition, the *Toys “R” Us* Court recognized the value to both buyers and sellers of deal certainty. The Court rejected the plaintiff’s argument that the board made an unreasonable decision to accept more deal protection in exchange for the certainty of receiving $26.75 per share. After a mathematical analysis, the Court concluded if the board had held out for its original request for a three percent termination fee, it would have risked KKR’s offer which was $1.50 per share higher than any other bid, simply to reduce the cost of the termination fee to another bidder by $0.20 per share. “Paying” $0.20 per share for increased deal certainty that guaranteed an additional $1.50 per share for stockholders enhanced stockholder value. The board’s decision not to risk the $26.75 per share price offered by KKR “in order to drop a second bidder’s marginal costs to an even slighter level does not appear to deter bids ...”

Furthermore, the Court promoted the notion that a combination of a matching right and a termination fee in a merger agreement are not unusual and do not deter an aggressive bidder from paying a
higher price. In doing so, the Court reminded the plaintiffs that each is a common contractual feature that, when used by a board to secure a high bid for the stockholders, has legal legitimacy. The Court cited several recent familiar transactions in which a third-party repeatedly bid for a target despite the existence of matching rights and a termination fee. As a result, the Court concluded that even though a termination fee and matching right acting in concert may prevent a third-party bid that are superior only by a relatively insubstantial amount, the defensive strategy employing them together was not draconian because “it is not the concern of our law to set up a system that promotes endless incremental bidding.”

Conclusion

Prior to Omnicare, most M&A professionals believed that a complete lock-up of a transaction would not necessarily constitute a breach of directors’ fiduciary duties, especially in circumstances where the merger premium was significant and there had been extensive pre-transaction “shopping” of the target. Not only did the Delaware Supreme Court in Omnicare seem to dispel this notion, but the Court went farther and concluded that a board’s latitude in using defensive devices varied according to the degree of benefit or detriment to stockholders offered by the subsequent transaction. In other words, a board’s good faith decision to agree to defensive devices would be subject to judicial review with the benefit of hindsight.

Even though the Court’s ruling in Orman arguably went too far in some aspects, most notably with the view that a lock-up period of eighteen months will not automatically be deemed unreasonable, the Delaware Chancery Court provided some clarity on the rules regarding the use of defensive devices. Still better, the Delaware Chancery Court in Toys “R” Us strongly expressed the principle that a board’s good faith decision regarding the use of defensive devices should be subject to a real-time review and should take into consideration the real world risks and prospects confronting directors when they agreed to the deal protections. Most importantly, both Orman and Toys “R” Us appear to have limited some of the harm triggered by the Omnicare decision.

NOTES

4. The Court noted that the record reflected that Genesis gave the NCS board less than 24 hours to vote in favor of the proposed transaction. In addition, Genesis insisted that the merger agreement include a “force-the-vote” provision and insisted that the merger agreement omit any effective fiduciary-out clause. Genesis also gave the two majority stockholders the same accelerated timetable to personally sign the proposed voting agreements. Genesis insisted on these defensive devices to avoid being used as a “stalking horse” to produce a third-party superior offer. NCS knew that Omnicare had spoiled a Genesis acquisition in the past and therefore NCS had a good reason to take Genesis’ ultimatum seriously. Omnicare, 818 A.2d at 934. Furthermore, at the time of the ultimatum, Omnicare’s proposal was expressly conditioned on negotiation of a merger agreement, obtaining certain third-party consents and completing due diligence. Omnicare, 818 A.2d at 924.
5. Id. at 936.
6. Id.
7. Omnicare, 818 A.2d at 943 (Veasey, N., dissenting).
8. To the dissent, the case was unique in two important respects. First, the dissent believed that the facts in the case were an unlikely candidate for repetition. Second, the case was a rare 3 to 2 decision of the Supreme Court. Omnicare, 818 A.2d at 940 (Veasey, N., dissenting).
9. Id. at 946.
10. The Court acknowledged that Section 251(c) of the Delaware General Corporation Law permits boards of directors to agree to submit a merger agreement to a stockholder vote, even if the board later withdraws its support for the agreement and recommends that the stockholders reject it, and also that Delaware law permits voting agreements.
11. NCS was in default on approximately $350 million in debt, including $206 million in senior bank debt and $102 million of its convertible subordinated debentures. After these defaults, NCS common stock traded in a range of $0.09 to $0.50 per share until the announcement of the Genesis transaction.
12. Had NCS insisted on a fiduciary-out provision, Genesis likely would have walked away from the transaction. The fiduciary out would have allowed the board to exit the merger in the event a superior offer came along, without breaching the merger agreement. This was Genesis’ fear from the beginning, as it had lost deals to Omnicare at the last minute in the past.
15. Omnicare, 818 A.2d at 934.
16. The Orman Court also acknowledged the practical difficulty of applying the balancing test. Orman, 2004 WL 2348395 at 35 n. 98.
17. Id.
18. The balancing test seems to be appropriate only when the board signs an agreement for a transaction that contains defensive devices at a time when it has received an actual superior bid or it has knowledge that an alternative bid might be coming in the near future. Even then the issue would remain one of knowledge and how the board could reasonably determine the benefit or detriment to its stockholders of such bid. Furthermore, how much more superior would the second offer have to be? Five percent? Fifteen percent? How similar would the conditions to the transaction have to be? These are only some of the questions that arise from the exercise of such a balancing test.

19. Omnicare, 818 A.2d at 932.
21. Id.

22. Comparing the lockup to a termination fee, the Court cited Brazen v. Bell Atlantic Corporation, 695 A.2d 43 (Del. 1997) and declared that the lockup did not cause the stockholders to vote in favor of the proposed merger for a reason other than the merits of the transaction. Quite the opposite, the Court stated that the deal would not have occurred without the inclusion of the defensive mechanism. Orman, 2004 WL 2348395 at 30–31.

25. Orman, 2004 WL 2348395 at 29 (citing Lacos Land Company v. Arden Group, Inc, 517 A.2d 271 (Del. Ch. 1986)). Arden’s principal stockholder and CEO made an explicit threat that unless certain proposed amendments were approved, he would use his power to block transactions that may have been in the best interests of the company. The threat to block transactions was unrelated to the merits of the proposed amendments under consideration by the stockholders and constituted impermissible coercion.

27. Akiko Mikumo, Recent Developments in Delaware Case Law Affecting Mergers & Acquisitions, 1486 PLI/Corp 141 at 190.
28. $247.5 million represented 3.75 percent of equity value or 3.25 percent of enterprise value.

29. A “naked no vote” refers to the scenario where the target’s stockholders vote to decline the merger agreement, but such rejections is not followed by the target’s acceptance of an alternative transaction.

31. Toys “R” Us, 877 A.2d at 1001.
32. Id. at 1001–1002.
33. Id. at 1021.
34. Id.
35. Id.
36. Id. at 1016.
37. Id.
38. Id. at 1020.
39. Id.
40. Id. at 1020–1021.
41. Id. at 1017.

42. In the clash for MCI, Qwest attempted to outbid Verizon, despite the existence of matching rights in the Verizon/MCI merger agreement. The case of Ace Limited v. Capital Re Corp, 747 A.2d 95 (Del. Ch. 1999), was triggered by a bid that topped an initial merger agreement that contained a termination fee and matching rights. The Court also recalled the “epic struggle” for Warner-Lambert between Pfizer and American Home Products. Toys “R” Us, 877 A.2d at 1020.
43. Id. at 1018.