Delaware Court Provides Guidance for Structuring Top-Up Options

Tender offers are becoming increasingly common in leveraged transactions, due in part to the recent acceptance of top-up options by the Delaware Supreme Court.[1] A top-up option is an option to acquire newly issued shares in a target upon the consummation of a tender offer. Top-up options are used to ensure that once the minimum tender condition is met, the bidder is able to acquire a sufficient number of the target's outstanding shares to allow for a short-form merger to be closed on the same day as the consummation of the tender offer. Top-up options are now nearly universally granted to buyers in negotiated tender offers.

In a recent decision by the Delaware Court of Chancery, Vice Chancellor Laster provided guidance for structuring valid top-up options.[2] In light of the *ev3* decision, we recommend addressing the following when structuring top-up options:

1. Appraisal Dilution

Although the Delaware Court of Chancery has not appeared to give much credence to claims that top-up options coerce stockholders to tender because of the threat of appraisal dilution, the parties should nonetheless consider including in the merger agreement a provision that in any appraisal proceedings the fair value of the dissenting shares shall be determined without regard to the top-up shares or their related consideration. In *ev3*, Vice Chancellor Laster noted that including such a provision fixes any uncertainty regarding the role of top-up options (and any related promissory note) in the appraisal process. An example of such a provision is as follows: "The parties agree and acknowledge that in any appraisal proceeding with respect to Dissenting Shares and to the fullest extent permitted by applicable Law, the fair value of the Dissenting Shares shall be determined in accordance with Section 262(h) of the DGCL without regard to the Top-Up Option, the Top-Up Option Shares or any cash or Promissory Note paid or delivered by MergerSub to the Company in payment for the Top-Up Option Shares."

2. Separate Deliberations and Vote for the Top-Up Option

Sections 152, 153 and 157 of the Delaware General Corporation Law require boards to determine the consideration for the issuance of stock and to control and implement all aspects of the creation and issuance of options. The target board of directors should thus separately consider and discuss the purpose of the top-up option, the mechanics of how it works, and its fiduciary duties in granting the option. These deliberations should be separately reflected in the minutes of the meeting and there should be a separate vote approving the top-up option.

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[1] *See, e.g., In re Cogent, Inc. S'holders Litig.*, No. 648, 2010 (Del. Oct. 19, 2010).
[2] *See Olson v. ev3, Inc.*, C.A. No. 5583 VCL (Del. Ch. February 21, 2011).

3. Consideration for Top-Up Shares

The exercise price for the top-up option should be specified in the merger agreement, as should the form of consideration, including the terms of any applicable promissory note. The target board must have the opportunity to consider the terms of the promissory note, and should explicitly approve such terms in its implementing resolutions. Rather than specifying the terms of the promissory note, the original merger agreement at issue in *ev3* merely provided that the terms would be set in the future, as determined in the first instance by the buyer and reasonably acceptable to the ev3 board. Vice Chancellor Laster noted that the amended provision, which is as follows, properly described the promissory note such that the ev3 board could analyze its terms in accordance with Sections 152, 153 and 157 of the DGCL:

> Any such promissory note shall be on terms as provided by the Parent of the Purchaser, which terms shall include the following: (i) the principal amount and accrued interest under the promissory note shall be payable upon the demand of the Company, (ii) the unpaid principal amount of the promissory note will accrue simple interest at the per annum rate of 3.0%, (iii) the promissory note may be prepaid in whole or in part at any time, without penalty or prior notice and (iv) the unpaid principal amount and accrued interest under the promissory note shall immediately become due and payable in the event that (x) Purchaser fails to make any payment of interest on the promissory note as provided therein and such failure continues for a period of 30 days or (y) Purchaser files or has filed against it any petition under any bankruptcy or insolvency law or makes a general assignment for the benefit of creditors.

4. Payment of the Par Value in Cash

Consider whether the merger agreement should provide for the payment of the aggregate par value of any top-up shares in cash. Although not required, Vice Chancellor Laster noted that providing for payment of the par value in cash eliminates any debate over whether the value of the consideration received might be less than the par value of the top-up shares.

5. Disclosing the Top-Up Option

To minimize the possibility of any disclosure claims in litigation relating to a top-up option, the parties should consider disclosing the material features of the top-up option, including the possibility that it would be exercised with a note. The disclosure document (Schedule 14D-9 or the Offer to Purchase) should also note the parties' disclaimer relating to the effect of the top-up option on appraisal proceedings.

Contact Information

If you have any questions about the *ev3* decision or structuring top-up options, please contact Keith Higgins, Paul Kinsella, Julie Jones, Jonathan Grandon, or your regular Ropes & Gray advisor.