Deal Certainty In Uncertain Times--2007 Lessons From The Delaware Court of Chancery

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In 2007, the merger market had distinct bull and bear phases, with each phase presenting challenges to public companies attempting to consumate mergers. In the first half of 2007, when credit and hungry acquirers were abundant, target companies and their acquirers sought to come to friendly terms quickly and then lock up their deals to them from challenge by follow-on bidders. Then, when the credit crunch hit and financing dried up, many acquirers began looking for ways to walk away from deals that suddenly seemed pricey. Together, the two phases produced a bumper crop of guidance from the Delaware Court of Chancery on how to structure merger negotiations and agreements to increase the likelihood that a merger will get done.

During the market updraft, targets and acquirers in friendly deals worried about hungry rivals attempting to snatch away their deal after the deal was publicly announced. To protect their deals, and the value they believed they had created, targets and their friendly acquirers looked for ways to bring mergers to closing even if it meant giving the stiff-arm to late-surfacing rival acquirers that might have had potential to make a superior bid if given enough time to do so. To do this, the friendly parties included "deal protection measures" in a merger agreement, such as (1) break up fees that typically cause the target to pay the acquirer a fee (typically 1% to 3% of the deal value) if the agreed-upon merger does not go forward; (2) "no shop" provisions to limit the circumstances under which the target can consider competing offers; (3) "force the vote" provisions that require a target to go forward with a stockholder vote even if the target's board has determined it no longer supports a merger; (4) voting "lock ups" under which officers, directors and key stockholders of the target contractually commit themselves to vote shares they control in favor the merger; and (5) "last look" or matching rights provisions. Deal protection measures tend to deter competing acquirers from coming forward with a rival bid.

In deals that do not involve a change in control (for example, a typical stock-for-stock or "strategic" merger), deal protection measures were generally held to be permissible and subject only to the reasonableness analysis under the *Unocal* case. In *Express Scripts, Inc. v. Crawford* (Feb. 23, 2007), the court confirmed that targets and acquirers in a stock-for-stock deal have broad latitude in agreeing to deal protection measures. Caremark, a pharmacy benefit manager ("PBM"), agreed to a friendly merger with drug-store giant CVS Corp that valued Caremark at $23 billion. Express Scripts, a rival PBM, made a topping bid that valued Caremark at $26 billion. Caremark refused to negotiate with Express Scripts, claiming that a tight "no shop" provision in its merger agreement with CVS required that Express Scripts agree to pay a $675 million breakup fee as a precondition to discussions. Express Scripts argued that $675 million "door-opener" was an unreasonable impediment that prevented Caremark's stockholders from having a chance to consider Express Scripts' bid. Although the court temporarily enjoined the transaction on disclosure grounds, it refused to grant an injunction based on Express Scripts' claim that the breakup fee, "no shop," matching rights and other deal protection measures were unreasonable. Finding that the deal protection measures did not threaten irreparable harm, the court declined to address their validity on the merits. The practical effect of the court's decision not to grant the injunction was to allow the deal protection measures to stand. In dicta, the court made clear that there is no bright line for when a breakup fee is simply too large, and thus unreasonable, and affirmed that deal protection measures often serve legitimate purposes protecting the friendly parties' deal.

In contrast to stock-for-stock deals, private equity firms acquire targets for cash. This constitutes a "sale of control," which is reviewed under the *Revlon* standard -- the target's board has the obligation to secure the best value reasonably available for the stockholders. Accordingly, the use of deal protection measures in a private equity transaction is subject to greater scrutiny than in a "stock-for-stock" transaction. Delaware law is reasonably clear that the selling corporation need not engage in a full public auction to satisfy *Revlon*. However, the target almost always must employ a pre-agreement or post-agreement "market check" to satisfy itself that it obtained the best value reasonably available for its stockholders. A pre-agreement market check involves identifying potentially interested acquirers before a merger agreement is signed. A post-agreement market check attempts to allow the target to secure the offer put forth by the initial bidder, but leaves the target open to pursue higher offers. Because the first bidder does not want to be used as a stalking horse for the target, the first bidder usually seeks to use deal protection measures to limit the post-agreement market check. However, a meaningful post-agreement market check requires that potential topping bidders have a fair opportunity to bid. Accordingly, if the deal protection measures are too strict, they may make the market check illusory and may run afoul of *Revlon*.

In 2006, the *Toys-r-Us* case had made it clear that targets have considerable discretion in designing and implementing a market check. But private equity deals add a wrinkle that caused the courts to apply increased scrutiny to market checks in 2007. During merger negotiations, private equity buyers frequently dangled delicious incentives in front of the target's incumbent management, in the form of new positions and new equity in the company post-acquisition. These potential benefits raised the concern that management might steer the target's board to an acquisition that management favored, even if the acquisition did not secure the best value reasonably available. In 2007, the Court of Chancery reviewed several transactions to determine whether the target had done enough to shop itself before agreeing to a locked-up merger agreement.

The decisions in *Netsmart* (Mar. 14, 2007), *Lear* (June 15, 2007), and *Topps* (June 14, 2007) provide guidance on how vigorously a target must pursue post-agreement market checks. In *Netsmart*, the court was highly critical of the target's decision to limit its search for potential buyers to private equity firms and failing to contact strategic buyers. Because the target, Netsmart, was a microcap company and not widely followed, it could not count on the deal announcement to flush out potential buyers. Although the market check that Netsmart used might have been appropriate for a more highly visible company, that same check may not have been an effective market check for Netsmart. Despite these defects in the market check, the court did not enjoin the Netsmart merger on *Revlon* grounds. Similarly in *Lear*, the court was highly critical of the way Lear's CEO negotiated many of the key merger terms outside the presence of special committee supervision. However, Lear was a large company, had removed its poison pill several years before, and had been subject of a drawn-out and public battle with activist investor Carl Icahn. Despite all this public attention, no competing bidders emerged for Lear. Thus, even though Lear's approach to negotiations fell short of best practices, the court found that it was not enough to demonstrate a breach of *Revlon* duties.

In *Topps*, the court's criticism focused on how Topps, the baseball card company, treated different bidders during a post-agreement market check. After agreeing to a buyout by a friendly investor, Topps was open to a 40-day "go shop" period. During the "go shop" process, Topps had required Upper Deck, a rival baseball card company that was interested in submitting a competing bid, to enter into a standstill agreement as part of due diligence. After terminating negotiations, Topps would not release Upper Deck from the standstill, which barred Upper Deck from making a topping bid. The court enjoined the friendly merger until Topps released Upper Deck from the standstill. The gist of the *Topps* ruling was that Topps' unfair treatment of an unfavored bidder, Upper Deck, may have made the post-agreement market check illusory.

The structural issues that private equity deals may raise, and that these three cases highlight, can be mitigated several ways. A pre-agreement market check is a safer way to proceed than just relying on a post-agreement market check. Similarly, it is important to explore, and perhaps solicit, potential strategic buyers. Finally, in performing either a pre-agreement or a post-agreement market check, it is important to treat all bidders fairly.

With the onset of the credit crunch, the fear of having an acquisition snatched away by topping bids waned. Instead, targets watched nervously while many acquirers looked for ways to re-price or terminate merger agreements. A remorseful acquirer's weapon of choice is often the material adverse change clause (a "MAC clause"), which may allow an acquirer to terminate a merger if there has been a material adverse change in the target's business. Although MAC clauses are hotly negotiated, they necessarily have some residual ambiguity and flexibility as to what exact circumstances trigger them. As a result, MAC clauses are fertile ground for litigation. Several cases concerning enforcement and interpretation of MAC clauses were filed in the second half of 2007. Some have settled, and none of these cases has resulted in a judicial decision on the merits. For now, it remains a truism that the Delaware courts have never found a material adverse change sufficient to allow an acquirer to walk away from a merger agreement under a MAC clause. But in all probability, this does not demonstrate that a material adverse change can never trigger a MAC clause.

As deals soured, targets scoured merger agreements to see what remedies they had against recalcitrant acquirers threatening to walk. Could the acquirer walk away from a deal and simply pay nothing or just the termination fee? Or could the target force the acquirer to perform under the merger agreement and go forward with the acquisition? *United Rentals* (Dec. 21, 2007) showed that the court will be reluctant to order specific performance of a merger unless the merger agreement clearly provides that specific performance is the exact remedy the parties intended. In addition, to the extent that the written words of the merger agreement are ambiguous on this issue, the evidence supporting specific performance must be clear and convincing. In *United Rentals*, private equity behemoth Cerberus wanted to walk away from its $7 billion dollar acquisition of United Rentals, Inc., an equipment rental company. Cerberus maintained it could do this by paying the $100 million termination fee. United Rentals argued that the merger agreement provided it with the remedy of specific performance. The court found that the merger agreement was ambiguous on this issue and that the parole evidence was more supportive of Cerberus. Significantly, the court held that deal counsel for United Rentals had deliberately left the specific performance issue ambiguous during negotiations concerning the merger agreement.

Deal certainty was a major issue both before and after the credit crunch, albeit for different reasons. No matter what direction the economy is moving, much can change between the date the merger agreement is signed and the date the merger is completed. The Court of Chancery's decisions in 2007 suggest that merger agreements must be negotiated to withstand both the frothy times of boom and the leaner times that inevitably follow.

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