TECHNIQUES AND STRATEGIES IN PROTECTING AN ACQUISITION TRANSACTION

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1. Introduction

1.1 Purpose Of Outline. This outline focuses on the various issues that must be considered in seeking to protect a negotiated corporate acquisition so that it does not break apart in a manner detrimental to the parties. During the period between the time a potential acquisition is first identified to the closing of the transaction, events and circumstances can arise to defeat its consummation. For instance, after a proposed acquisition is publicly announced, competing bidders can intervene to make a better offer that thwarts the acquiror's proposal. And, there is always the risk that an event will occur that prevents a closing condition from being satisfied thereby triggering a termination of the deal. The repercussions of a busted deal can be adverse to the constituent companies. Indeed, many a would-be acquiror has turned out to be merely a "stalking horse" for the sale of a target company because its proposed deal slipped away without its receiving any financial compensation even though its efforts ultimately led to a favorable deal for the target company's stockholders. And, in those cases where an acquiror legitimately walks away from a publicly announced transaction, the target company can suffer great harm because it may then be viewed in the market place as being "damaged goods." In light of the potential downside to a busted deal, taking steps to protect a proposed corporate acquisition is typically very important to both sides of the transaction (although some sellers have found that leaks can conveniently improve their bargaining position with the acquiror).

1.2 Role Of Legal Counsel. Legal counsel will play a major role in assuring that a proposed transaction does not unravel except under limited conditions negotiated between the parties. The lawyer's role will begin at the earliest stages of a proposed transaction. While each party will expect its own counsel to negotiate an "air-tight" legal document from its viewpoint, no acquisition agreement (especially a heavily negotiated one) can ever be made totally bullet proof against the risk of not closing. For that reason, it is incumbent on legal counsel to carefully analyze and advise the client about the pertinent risks in not consummating a transaction and then to negotiate contractual provisions that reasonably protect the client against such risks. This outline discusses certain transaction risks and the strategies for protecting against them.

1.3 Perspective Of Outline. This outline is written primarily from the perspective of negotiating and consummating an acquisition transaction in which the target is a public company. Transaction risks and the methods for dealing with them as described in this outline have, for the most part, limited application to the acquisition of a private company by a public company. It should also be noted that most of the issues discussed in this outline are applicable whether the acquiror uses cash or its stock as currency for completing the acquisition. However, as noted below, stock-for-stock transactions can present some special risks in getting a transaction consummated. Even so, in contrast to a cash acquisition, the interests of the acquiror and the target company in a stock-for-stock transaction will be more identical insofar as each performs due diligence on the other and takes appropriate steps to protect the transaction.

1.4 Initiating The Deal Process. The starting point of an acquisition can occur in several ways. It can begin by the target company's decision to put its self up for sale. In accomplishing that objective, the target company will often seek the aid of an investment banking firm in conducting a full blown auction process. Or, the target company may decide to approach a selective number of potential acquirors to get an indication of interest and then proceed to negotiate with a few or perhaps only one. The advantage of singling out one potential acquiror is to induce a pre-emptive bid ("blow out" bid) for the target company. In other cases, a target company may seek a stock-for-stock merger with another entity (including a competitor) for strategic reasons. And, of course, management-led leveraged buyouts are always a possible means of achieving a sale of the target company. But, regardless of the avenue taken, the sale of a company always requires careful orchestration in order to comply with the fiduciary duties of the seller's board of directors and to avoid the company becoming "worn goods" in the market place if the attempted sale fizzles.

Another starting point for an acquisition is where a potential acquiror identifies an acquisition and then proceeds to contact the target company to determine its level of interest. While the would-be acquiror may be "shown the door," preliminary discussions can often lead to serious acquisition negotiations. Early on, the attitude of the potential acquiror toward pursuing a

hostile takeover must be considered. Most certainly, it will be a major concern to a target company's management when it is contacted about entering into friendly acquisition discussions. Of course, some acquirors may enter the acquisition picture as a "white knight" in a hostile contest. In any event, initiating discussions with a target company requires advanced planning by the acquiror and its advisors regardless of what triggers those discussions.

In initiating acquisition discussions, legal counsel for the acquiror and the target company will be asked to analyze and develop legal strategies aimed at achieving the desired objective. Putting together the working group, selecting the best acquisition ploy, selecting the best transaction structure, organizing due diligence efforts and putting in place procedures for avoiding premature disclosures of the proposed deal will be of the first order for each respective party. Once an agreement in principle is reached, legal counsel will then assist the client in the negotiation of a definitive agreement and ultimately, in closing the deal. Set forth below is a discussion of these routes and the strategies that need to be considered in helping protect the deal.

2. Avoiding Premature Disclosure of the Deal

2.1 Adverse Effects Of Premature Disclosure. The number one objective in protecting any proposed corporate acquisition is to get a binding agreement executed by the parties prior to any leak to the public and before any formal disclosure of the deal is legally required to be made. For that reason, parties to a negotiated acquisition must strive to maintain secrecy and confidentiality until an agreement has been entered into by the parties. In the same vein, legal counsel and the other members of the negotiating team for each party must move along the deal process (including due diligence and the preparation of definitive documents) in an expeditious manner. In sum, the parties must push quietly and quickly to achieve their objective. The following are some of the problems that can be encountered if secrecy is not maintained thereby resulting in an untimely disclosure of a proposed acquisition prior to the execution of a definitive agreement.

2.1.1 Putting The Deal Into Play. Public disclosure of acquisition negotiations will often invite competing bids from other potential acquirors. This will be especially true if the disclosure occurs before a binding agreement is put in place. In that event, the would-be acquiror will be very vulnerable since it will have no contractual right to a "bust-up fee" or a "topping fee" (as discussed in Section 5 below) if it ultimately loses the deal.

Observation. The need for secrecy is not as relevant when a company is offered for sale in the market place through an auction process. But a company's board of directors is not always required by its fiduciary duty to hold an auction or otherwise "shop" the company prior to entering into a negotiated acquisition agreement especially in the case of a strategic stock-for-stock merger ("merger of equals"). See Section 7 below for a discussion of a board's fiduciary duties in connection with a sale of a company.

2.1.2 Disruption Of Relationships With Employees, Customers, Etc. Every precaution must be taken to preserve the vitality of the operations and third-party business relationships of the constituent companies while a proposed acquisition is pending. When a transaction is leaked to the public in an untimely manner, there is usually little substantive information available that addresses the impact of the potential acquisition on the many individuals and entities that have interests in the constituent companies. Without detailed information, the employees of the constituent companies are likely to become concerned that the acquisition will lead to job losses and to adverse changes in employee benefits and the corporate culture. Customers and suppliers will also likely be concerned that the transaction will cause disruptions in a company's business operations to the point that it adversely affects the business that they conduct with the company. By avoiding an untimely disclosure, the parties can adequately plan in advance on how

to positively address the concerns of the various stakeholders and to otherwise avoid major disruptions in its business relationships with its employees and third parties.

2.1.3 Harmful Backlash From Failed Negotiations. Acquisition negotiations often fail for reasons that should not, in and of themselves, reflect negatively on either company. Of course, when secrecy is maintained, there will be no adverse repercussions from the termination of negotiations. On the other hand, when the public has already learned of negotiations, their subsequent termination can be harmful to the parties. Without doubt, market speculation about why a deal was aborted can adversely affect the stock price of the securities of the constituent companies plus it can tarnish their business reputations.

2.1.4 Jeopardizes Economic Terms Of The Deal. Premature disclosure of deal negotiations can also have an adverse effect on the ability of the parties to reach an agreement on the economic terms of the proposed transaction. For instance, leaks to the public can generate unrealistic market speculation about the dilutive effect of the acquisition transaction on the acquiror's stockholders. A resulting decrease in the acquiror's stock price can make a proposed stock swap unattractive to the point that it even kills the deal. On the other hand, premature disclosure may result in a substantial increase in the target's stock price (i) to a level that effectively eliminates the contemplated premium in the acquiror's proposed offer price over the target's stock price or (ii) much worse, to a level actually greater than the acquiror's proposed offer price. Suffice it to say, "take under" transactions (i.e. where an acquiror's offer price is less than the current stock market price) can sometimes create a major obstacle in getting a deal done.

Observation: A definitive acquisition agreement can provide contractual protection against major changes that occur prior to closing in the market value of the securities of the constituent companies through the use of various pricing mechanisms (such as floating exchange ratios, "floors," "caps," "collars," walkaway rights and topping-off rights). However, these mechanisms can be substantially undermined if rank speculation occurs in the stock market before the definitive agreement can be finally negotiated and executed. In sum, major fluctuations in the price of the securities of either of the constituent companies during the period of negotiations can severely interfere with the negotiations of price and the related contractual provisions in the definitive agreement. As a result, the viability of proceeding with the proposed acquisition can be put in jeopardy.

2.2 Key Factors In Maintaining Secrecy. While secrecy is accomplished primarily by using common sense, the following are some of the typical steps that parties will adopt to help prevent premature disclosure.

2.2.1 Limit Participants. The risk of premature disclosure increases with each additional person who knows that negotiations are taking place. Naturally, limiting the number people in the working group will reduce the risk that a confidentiality breach will occur. For that reason, a party's negotiating team (including investment bankers, accountants and lawyers) should include only those persons who are absolutely essential to getting the deal done expeditiously.

Observation. Director participation can also present difficult issues in maintaining secrecy. For that reason, a company may find it advisable to limit its initial briefings about the proposed deal to its executive committee until negotiations have reached the point that a definitive agreement can be presented to the board for its approval. Of course, the entire board will need to be thoroughly briefed in advance of deliberations and will subsequently need to be given adequate time to deliberate the merits of the proposed transaction prior to voting on its approval if they are to satisfy their fiduciary duties. (*Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).) See Section 7 below for a discussion of such fiduciary duties.

2.2.2 Emphasize Confidentiality To Participants. A company cannot afford to assume that every participant will understand the need for confidentiality and the risks related to a premature disclosure of the transaction. Accordingly, as each person is advised of the potential transaction, he or she should be strongly cautioned against inadvertent disclosure. Counsel may also need to brief less sophisticated participants on "tipper/tippee" liability.

2.2.3 Control Access To Document Drafts, Memos And Other Deal Communications. Participants in a deal should be cautioned on the distribution and handling of all documents and electronic information so that appropriate steps are taken to keep the information from being inadvertently viewed by persons outside the working group. The parties should be very sensitive to the adequacy of security with respect to documents prepared or processed on a computer network. In that connection, it is appropriate to maintain hard copies of document drafts and due diligence reports in an area that has restricted access.

2.2.4 Use Of Code Names And Designation Of Documents As "Confidential." In transmitting written communications and in very limited circumstances, oral conversations, code names often are used in lieu of company names. Documents prepared for circulation also often omit other potentially identifying information such as addresses and names of company officers and directors. Of course, in transmitting documents, it is normal for transmittal letters and memos to clearly state that the documents are confidential and to contain an appropriate warning to that effect.

2.2.5 Secure Meeting Locations. The parties must also be very careful not to conduct negotiations at locations which might attract attention to their activities. For that reason, some companies will insist that negotiations always be conducted at neutral locations. Others may even insist that at least the initial meetings be held in cities in which neither company is located and that they be conducted during weekends or otherwise outside normal business hours.

2.3 Considerations In Conducting Due Diligence Prior To Public Disclosure Of The Deal. As a practical matter, extensive and time consuming due diligence will be almost impossible if secrecy and speed are critical to protecting the deal. This means that the parties must rely principally on limited due diligence up and until the time that a definitive agreement is executed and publicly announced. For that reason, this due diligence effort must be carefully orchestrated to not only maintain secrecy but to also primarily focus on the "big" issues. In other words, under these kinds of restraints, the due diligence effort cannot afford to be broad brush but instead it must follow a rifle shot approach to be effective. Set forth below are common approaches to achieving that objective.

2.3.1 Public Filings And Oral Inquiries. If the target is a public company, then the potential acquiror can thoroughly review the target's SEC filings. In the case of a private company, the target company should, within reasonable parameters, be expected to promptly furnish the acquiror with fundamentally the same information that SEC filings would have contained. In either case, the acquiror must quickly gather sufficient substantive information about the target so that its oral inquiries with the target's management will be meaningful. With the help of the investment bankers, accountants and lawyers, the acquiror will usually be able to put itself in a position to make an informed decision on the major deal terms prior to executing a definitive agreement. Moreover, the acquiror can seek to negotiate reasonable representations and warranties in the definitive agreement which effectively compliment its preliminary due diligence efforts *(see Section 4.3.2 below)*.

2.3.2 Focus On Soft Spots And Potential "Deal-Killers." When due diligence must be limited in scope, each party must focus quickly on issues that could cause the parties to abort the negotiations or, after a definitive agreement is executed, cause the deal to be

abandoned. For instance, the parties must determine if any antitrust experts will need to be consulted when there is a significant likelihood that the proposed transaction will be challenged on antitrust grounds. Likewise, since environmental liability risks can be "show stoppers," immediate attention must also be given to those issues. And, the likelihood of obtaining necessary third-party consents and the resulting costs to do so must be carefully evaluated. "Change of control" provisions in debt instruments and other contracts of the target company can also be very problematic in closing a transaction so due diligence of those matters is very important. In considering the proposed transaction structure, the risks in obtaining "pooling" accounting treatment and tax-free reorganization treatment must be analyzed. Also, there must be sufficient inquiries as to whether certain members of the target's management must be agreeable to signing on with the acquiror. As the last illustration of how acquirors should focus on material issues, contingent liabilities of the target must be carefully evaluated by the acquiror with the help of legal counsel and others.

2.3.3 Contractual Assurances. As discussed more fully in Section 4.3.2 below, representations and warranties in the definitive agreement should be aimed at ferreting out major weaknesses in the target company that cannot be satisfactorily investigated prior to the execution of the definitive agreement. In essence, many times an acquiror will view detailed representations and warranties from the target company as a key method of achieving due diligence prior to closing. However, it should be noted that a seller's representations and warranties can sometimes be very limited in scope when the target company has substantial bargaining power and is a SEC reporting company. In those cases, the target company may take the negotiating position that it will give only a general 10b-5 representation as to its SEC filings and perhaps, a few limited representations covering certain issues unique to the target company.

2.4 Making Open Market Purchases Prior To Public Disclosure. As part of their acquisition strategies, some acquirors will often accumulate shares of a target company prior to beginning negotiations. Since the accumulation of shares that may reach certain ownership thresholds that require public disclosure under federal securities laws and/or other regulatory requirements, care must be taken to assure that open market purchases do not force the untimely disclosure of a potential acquisition transaction. After all, a public filing indicating the acquisition of a major block of stock can easily be a signal to other potential acquirors and to the stock market that a potential acquisition of the target company is just around the corner. Set forth below are certain disclosure requirements that must be considered by the acquiror in planning the acquisition of securities prior to obtaining a signed acquisition agreement.

2.4.1 Securities Laws.

(i) Section 13D. Section 13(d) of the Securities Exchange Act of 1934 (the "1934 Act") requires any person or "group" who acquires "beneficial ownership" of more than 5% of any class of registered equity security to file a report on Schedule 13D. The Schedule 13D (i) must be filed with the Securities and Exchange Commission (the "SEC"), the issuer and each exchange on which the security is traded, (ii) must be filed within ten days of the acquisition, (iii) must identify the acquiror and (iv) among other disclosures, must state the purpose or purposes of the acquisition of securities and describe plans or proposals that the acquiring person may have with respect to the issuer. SEC Regulations require that a Schedule 13D be amended promptly (generally deemed to mean within ten days) after any material change occurs in the facts set forth therein.

(ii) Section 16(a). Section 16(a) under the 1934 Act requires periodic reporting of the purchase and sale of equity securities of a public company by its officers, directors and 10% holders.

2.4.2 Hart-Scott-Rodino Notice Filing. A Hart-Scott-Rodino filing is required if (i) the acquiror purchases more than $15 million of securities of the target company, (ii) either the target company or the acquiror has sales greater than $10 million and (iii) either the target company or the acquiror (whichever was not addressed by subsection (ii)) has assets or sales of more than $100 million.

2.4.3 Anti-Takeover Issues. Open market purchases by a potential acquiror also may cause problems under (i) an issuer's poison pill (which may have a very low trigger point (e.g. 5% stock ownership) and which may require aggregation of securities owned by the potential acquiror and certain other parties who are deemed to be related to, affiliated or associated with the acquiror or otherwise acting in concert with the acquiror), and (ii) anti-takeover statutes (such as Section 203 of the Delaware General Corporation Law and control share acquisition statutes that are in place in some states).

2.4.4 Regulated Industries. In the case of regulated industries, there are often regulations that require public reporting of stock ownership at certain threshold levels. For example, the acquisition of more than 5% ownership of voting securities of a bank or insurance company can trigger a notice requirement to the regulators.

2.5 Duty to Disclose Under The Federal Securities Laws.

2.5.1 Background. A public company's duty to publicly disclose corporate information arises primarily under the federal securities laws. The Securities Act of 1933 (the "1933 Act") requires companies to make full disclosure of material information to prospective investors in connection with the sale of securities by a company. In contrast, the 1934 Act focuses on regulating trading in securities of public companies by imposing ongoing disclosure requirements on these companies. Under the 1934 Act, issuers are required to file with the SEC periodic reports (Forms 8-K, 10-Q, 10-K, etc.) to keep the market informed of current material information. Publicly-traded companies also are subject to disclosure requirements imposed by the stock exchanges on which their securities trade. The stock exchanges generally require prompt public disclosure of material developments through press releases. Finally, public companies are subject to an implied duty of full disclosure under the anti-fraud provisions of the federal securities laws (most notably under Rule 10b-5 promulgated by the SEC pursuant to Section 10 of the 1934 Act).

The courts have consistently held, however, that the mere possession of material information does not in itself trigger the duty to make public disclosure. *See e.g. Roeder v. Alpha Indus., Inc.* 814 F.2d 22 (1st Cir. 1987). Even though there is no general duty to disclose material information, there are several identifiable circumstances in which a duty of disclosure arises or may arise, including the following: (i) where prior disclosure was materially misleading when originally made (the so-called "duty to correct"); (ii) where prior disclosure regarding certain "forward looking matters", although correct when originally made, has become materially misleading (the so-called "duty to update"); and (iii) where an "insider" wishes to trade in the securities of the issuer while in possession of material non-public information ("insider trading"; the so-called "disclose or abstain from trading rule").

2.5.2 The Materiality Standard. The foregoing disclosure requirements apply only to "material" information. Unfortunately, no objective or empirical formula defines "material" information. However, the standard of materiality is set forth in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), which involved claims (based on alleged violations of Section 14(a) of 1934 Act) against TSC Industries by Northway, Inc., a shareholder of TSC Industries, alleging that a joint proxy statement was incomplete and misleading. Northway asserted that TSC and National, the acquiror of TSC, failed to include "material facts relating to the degree of National's control over TSC and the favorability of the terms of the proposal to TSC shareholders" in the proxy

statement. The Court indicated it feared that an extremely low standard of materiality would subject corporations to a significant amount of liability. *Id.* at 448. Therefore, the Court established the general standard of materiality, as follows:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the `total mix' of information made available.

Id. at 449.

See also, Rules 405 and 12b-2 adopted by the SEC under the 1933 Act and the 1934 Act, respectively: "material" information is information ". . . to which there is a substantial likelihood that a reasonable investor would attach importance" in determining whether to purchase or sell a security.

In 1982, the Third Circuit held that no duty of disclosure arises until the parties to a proposed acquisition transaction have reached a fundamental agreement to do the deal including reaching an agreement on the "price and structure" (*Staffin v. Greenberg*, 676 F2d 1196 (3d Cir. 1982). Relying on that precedent, it was generally assumed that disclosure of a deal was only triggered when a letter of intent or definitive agreement were signed. However, the Supreme Court, in *Basic Inc. v. Levinson*, 108 S. Ct. 978 (1988), found that the materiality standard under Rule 10b-5 for preliminary merger discussions is to be determined on a case-by-case basis and "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." (*Basic* at 987, citing *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968)). In its holding, the Court specifically rejected the "agreement-in-principle" test, under which preliminary merger discussions are not considered material until the parties reach an agreement as to the price and structure of the transaction, in favor of *Basic's* probability/magnitude test. Furthermore, the Court embraced the standard outlined in *TSC Industries, Inc. v. Norway*, Inc. 426 U.S. 438 (1976) in which it was held that for an omitted fact to be considered material, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" (*Basic* at 983, citing *TSC Industries at 449*).

Lower courts have relied on the probability/magnitude test of *Basic* to determine materiality in the context of preliminary merger negotiations and takeover discussions. See *Taylor v. First Union Corporation of South Carolina*, 857 F.2d 240 (4th Cir. 1988), *cert denied*, 489 U.S. 1080 (1989) (no disclosure necessary because merger discussions too preliminary, contingent and speculative to be material); *Jackvony v. RIHT Financial Corporation*, 873 F.2d 411 (1st Cir., 1989) (without pre-merger events, a company's general interest in a merger is not material and does not have to be disclosed); *Hartford Fire Insurance Company v. Federated Department Stores*, Inc., 723 F. supp. 976 (S.D.N.Y. 1989) (no disclosure required as pre-negotiation prospects and hypothetical takeover possibilities are not material).

2.5.3 Timing The Disclosure Of A Corporate Acquisition. In the context of a proposed acquisition, the test of materiality as adopted in Basic can be satisfied at any point (even during preliminary negotiations or upon execution of a letter of intent) depending upon the facts. But, once it is determined that a potential acquisition constitutes "material information," the timing of its disclosure to the public is the next decision. Set forth below in Sections 2.5.4 and 2.5.5 is a discussion of the circumstances that will generally justify delaying disclosure and those that will generally not permit any such delay. In

view of the fact-specific nature of this disclosure duty in the context of a proposed acquisition, legal counsel must continually monitor market conditions, the trading in the company's securities and the status of the acquisition negotiations so that it can fully advise the client on when disclosure of the transaction is legally required.

2.5.4 Circumstances Which Legally Justify Delaying Disclosure Of A Proposed Acquisition. Although public companies generally cannot avoid public disclosure of material information, they can, under the right circumstances, legally delay such disclosure until an appropriate time. The following are reasons by which a public company may legally justify delaying disclosure of material information.

(i) Information "Not Ripe" For Disclosure. The courts have recognized that tentative and indefinite information may not be ripe for disclosure, even though it may involve material matters. The risk of misstatement overrides the necessity of disclosure. Thus, a company may justifying delaying disclosure while it verifies information and becomes satisfied with the certainty of the matter. The question whether information is "ripe" for disclosure is related to the question whether information is material under the *Basic* test described above. Preliminary acquisition negotiations that have a high likelihood of failing may be deemed immaterial under the *Basic* test or "not ripe" for disclosure, in each case because of the uncertainty surrounding such negotiations.

(ii) Valid Business Reason Exists For Delaying Disclosure. Courts have also recognized that a company can be legally justified in delaying disclosure on the grounds that it may gain a benefit or avoid a loss through such delay. Courts have applied the business judgment rule in testing boards of directors' decisions to delay disclosure for valid business reasons. For example, under appropriate circumstances, a company's need to complete acquisition negotiations before identifying the target to competing bidders might constitute a valid business reason for delaying disclosure of the proposed transaction. However, as disclosed in Section 2.5.5 below, there are circumstances where even a valid business reason will not excuse delaying disclosure.

Observation. In deciding to delay disclosure, it is important to recognize that the process by which that decision was made is very important if the company is later challenged. In that regard, a plaintiff must prove "scienter" (generally, an intent to deceive, manipulate or defraud) to succeed in a claims for securities fraud under Rule 10b-5. Recklessness is sufficient to prove scienter. Therefore, a company that decides to delay disclosure of a proposed acquisition (even though it may constitute material information) should establish a record that can later be used to demonstrate its good faith and diligence in determining the relevant facts and circumstances that justify such a delay. With the help of legal counsel, the company also should demonstrate that after making its decision to delay disclosure, it continued to exercise diligence by closely monitoring its decision so that an immediate disclosure could be made if changed circumstances made the delay no longer justified.

2.5.5 Circumstances Which Do Not Legally Justify Delaying Disclosure Of A Proposed Acquisition.

(i) Trading In The Company's Securities. Even though a company may have a valid business reason for delaying disclosure, it will generally not be excused from making prompt disclosure of material information about a proposed transaction if the company or its officers, directors or other insiders are then engaged in transactions in the company's own securities. This would also be the case if material information has been selectively disclosed to third parties and the company has reason to believe that these third parties are trading on such information. Bottom line, this means that a public company cannot justify

delaying disclosure of an acquisition transaction if at the same time, it is engaged in selling its own securities or engaged in open market purchase transactions in its own securities.

(ii) Misinformation In The Market Place. A public company has an affirmative duty to correct prior statements that the company has made and on which the public is continuing to rely. For instance, a prior disclosure by the company that it is not for sale or is not engaged in any substantive merger negotiations may become misinformation if an agreement in principle is reached on an acquisition deal within close proximity to the time of such prior disclosure.

3. Legal Arrangements Prior to Striking a Deal

3.1 Overview. At the very start of acquisition negotiations, it is common for the parties to enter into an agreement that prescribes their understanding regarding the confidentiality of corporate information gained through negotiations and due diligence activities. Additionally, when the target is a public company, it will insist that the acquiror enter into an agreement that restricts the acquiror from purchasing securities of the target company except as permitted by the terms of the agreement. These pre-negotiation agreements are intended to protect the parties in the event a transaction is not ultimately negotiated and closed between them.

3.2 Confidentiality Agreements. Evaluating the merits of a proposed corporate combination will obviously require an exchange of corporate information between the parties. Needless to say, the release of proprietary and other confidential information to a third party presents obvious risks to a company especially when the third party is a competitor. For that reason, companies are unwilling to proceed with the exchange of non-public information and in some cases, even with very preliminary acquisition discussions unless the other party first enters into a confidentiality agreement. Confidentiality agreements are intended to ensure that any confidential information revealed to the other party (i) is kept confidential and (ii) is used only in connection with analyzing the proposed transaction.

Observation. A target's level of concern about confidentiality issues depends on many factors. A target that is being courted by a "strategic" acquiror (typically a competitor) will be extremely concerned about restoring the status quo ante if the negotiations are unsuccessful. On the other hand, a target that is being pursued by a "financial" buyer (typically an acquisition fund or a company that does not otherwise compete in the target's business) may be less concerned about ensuring no misuse of information if negotiations fail. Moreover, the nature of the information to be disclosed also will be relevant in negotiating the scope of a confidentiality agreement. Obviously, truly proprietary information (for example, formulas and product specifications) will require special treatment to assure that no competitive advantage is lost if the transaction is not made.

Attached to this outline as Exhibit A is a sample form of a confidentiality agreement. The following are key issues that must be considered in negotiating and drafting a confidentiality agreement.

3.2.1 Binding Effect of a Confidentiality Agreement. Of course, the primary parties to a confidentiality agreement will be the acquiror and the target company. In addition, some target companies will request that a confidentiality agreement be executed also by the acquiror's outside advisors because they will also have access to the confidential information. But few advisors are willing to enter into such agreements. So, in lieu of that requirement, targets will often accept an agreement by the acquiror that it will be liable for any improper use or improper disclosure of the confidential information by any of its advisors. In that case, the target company may insist that the acquiror limit the recipients of confidential information to its officers, directors, investment banker, legal counsel, accountants and other agents on a "need to know" basis and the acquiror may seek some kind of commitment from its advisors regarding the use of confidential

information. The objective here is to make sure that the confidential information is carefully treated by the receiving party.

3.2.2 Definition of "Confidential Information." Obviously, a key negotiation point will be how the parties define what information constitutes confidential information for the purposes of the agreement. The term "confidential information" is generally described as including all information actually disclosed by the target company, whether orally, in writing or by any other medium and whether disclosed before or after the execution date of the confidentiality agreement. This definition will sometimes include all reports, summaries, analyses and personal notes prepared by the acquiror or its agents that contain, reflect or are based on the confidential information provided by the target company. To prevent unintentional violations of the confidentiality agreement and to avoid subsequent disputes over what written material was confidential, it is sometimes agreed that the only written material that falls within the "confidential information" definition is that which is marked "Confidential" by the party providing the information.

Excluded from the definition of "confidential information" are typically the following: (i) information that is or becomes public other than through the fault of the acquiror or anyone who obtained confidential information from the acquiror, (ii) information possessed by the acquiror prior to its disclosure by the target and (iii) information disclosed to the acquiror by a third party who is not, to the acquiror's knowledge, prohibited from disclosing such information. The acquiror also may try to exclude information that it develops independently of the information disclosed by the other party.

3.2.3 Return or Destruction of Confidential Information. A target company usually requires that all confidential information (which was furnished by it) must be returned or destroyed upon termination of the negotiations. Typically, information prepared by the proposed acquiror based on the confidential information will also fall within this requirement. Some confidentiality agreements will require that a senior executive officer of the other party certify in writing that all the confidential information has been returned or destroyed if and when the deal is aborted.

3.2.4 Permitted Disclosure Of Confidential Information. A confidentiality agreement will normally permit a recipient to disclose confidential information when such disclosure is required "by law." Obviously, a party cannot be bound to the point that it is contractually prohibited from answering a subpoena issued by a court or governmental agency. In that regard, a confidentiality agreement will typically require a party (i) to notify the target of the subpoena so that other party can challenge the disclosure requirement, (ii) to cooperate (typically on a best efforts or commercially reasonable efforts basis) with other party in challenging disclosure requirement and (iii) to disclose only that portion of the confidential information that the other party's counsel advises is required to be disclosed.

3.2.5 Antitrust Considerations. The Federal Trade Commission has cautioned businesses that when due diligence is conducted between competitors, they must be very sensitive to the risks of potential antitrust violations if the parties do not ultimately consummate a transaction. Anti-competitive effects can emanate from the sharing of product lists, customer lists, pricing lists, and other marketing information. For these reasons, a confidentiality agreement should restrict the respective competitors in the manner in how they can use such information so that the risk of creating antitrust problems is minimized. Often the most sensitive information is exchanged at the end of the negotiation process when it looks like the deal will make.

3.2.6 No Representation or Warranties. A target company generally will disclaim any representation or warranty as to the accuracy and completeness of the confidential information disclosed pursuant to the confidentiality agreement.

3.2.7 No Obligation to Continue to Negotiate. Not wanting to inadvertently become legally bound to do a deal, the parties to a confidentiality agreement will often insist that the agreement expressly state that neither party is obligated to continue to negotiate in good faith or to enter into any binding agreement relating to the negotiations.

3.3 Standstill Agreements. Target companies are always concerned that negotiations, which begin on a friendly basis, will later become unfriendly and ultimately lead to a hostile takeover bid by the potential acquiror. For that reason, a target will be very reluctant to engage in negotiations and to exchange information without some contractual protection against an uninvited bid from the would-be acquiror. Thus, most public companies will require that a potential acquiror enter into a standstill agreement prior to negotiations. The scope and term of a standstill agreement must be carefully evaluated by the potential acquiror. An acquiror who is set on acquiring the target will resist entering into a standstill agreement so that it can keep open the option of commencing a hostile takeover. Of course, the downside of passing up an opportunity to negotiate a friendly deal must be carefully weighed by an acquiror (especially where the acquiror has exclusive negotiation rights for a specified period).

Standstill arrangements are negotiated on a transaction-by-transaction basis and are less standardized than confidentiality agreements. While a standstill arrangement can stand alone, it is commonly included as a provision in a confidentiality agreement. Attached to this outline as Exhibit A is a form of confidentiality agreement that contains a typical standstill agreement. Set forth below are the key elements to be negotiated in a standstill arrangement.

3.3.1 Term; Remedies. Standstill agreements typically are effective for a specified term, usually one to five years. If the standstill agreement is included as part of the confidentiality agreement, then the acquiror should be careful to ensure that the standstill provision is not perpetually effective, as the confidentiality agreement may be. The acquiror also should be sure that any remedies (such as injunctive relief) and other "miscellaneous" provisions included in the confidentiality agreement are appropriate for the standstill provisions or are expressly not applicable to the standstill provisions.

3.3.2 Prohibitions A comprehensive standstill agreement may prohibit the proposed acquiror from doing any of the following until the acquiror is invited to do so by the target's board of directors:

(i) purchasing or otherwise acquiring any securities of the target,

(ii) forming, joining or otherwise participating in any "group" (within the meaning of Section 13(d)(3) of the 1934 Act) with respect to the target or its securities,

(iii) proposing to the target's stockholders, or making any announcement with respect to, any transaction between the acquiror and the target or involving the target, its stockholders or the target's securities,

(iv) seeking to control or influence the target or its management through the solicitation of proxies or consents, or participating in any such attempt,

(v) assisting, advising, encouraging, providing any information to or providing any financing to any other persons seeking to acquire, directly or indirectly, control of the target, its management, its board of directors, securities, business or assets or

(vi) requesting that the target amend, or grant any waiver under, the standstill agreement or otherwise requesting that the target's board permit the acquiror to take any action prohibited by the standstill agreement.

The foregoing list is not exhaustive. Standstill agreements may address other issues of concern to the target and may be tailored to reflect pre-existing stock ownership in the target company by the potential acquiror. Standstill agreements also may be tailored to coordinate with anti-takeover devices such as poison pills or applicable anti-takeover statutes.

3.3.3 Termination Of Standstill Prohibitions. A target company's purpose in requesting a standstill agreement is to help ensure that the target can remain independent if no consensual deal can be negotiated with the proposed acquiror. An acquiror may argue, however, that the standstill agreement should not prevent the proposed acquiror from participating with other potential acquirors in any bidding contest that develops other than as a result of actions taken by the acquiror. The proposed acquiror may request a provision in the standstill agreement that terminates the standstill obligations if the target company enters into an agreement with any other acquiror, initiates a "market check" or seeks to "auction" the company.

Observation: Before entering into a confidentiality/standstill agreement, an acquiror must recognize that because it will have reviewed *material* nonpublic information about the target company, it may face a difficult situation if a bidding contest later develops for the target. If the target does not properly disclose all material information known by the acquiror, then whether or not the standstill prohibitions terminate upon development of the bidding contest, the acquiror may not be able to make an offer due to the prohibitions against trading on inside information. In that case, an acquiror's only available avenue for acquiring the target company may be a friendly negotiated transaction.

3.3.4 Fiduciary Duty Issues. Standstill agreements present fiduciary duty issues for the target's board of directors. Generally speaking, a target's board should not utilize standstill agreements in a manner that would adversely affect a potential acquiror's ability to participate in a bidding contest. The Delaware courts have made it abundantly clear that the target's board can run afoul of its fiduciary duties if it creates an "unlevel playing field" for would-be acquirors. Nonetheless, if the target company is not "in play" (for example, if the target's board is considering only a stock-for-stock merger with a strategic acquiror and is not considering other change of control transactions), then a standstill agreement may be appropriate.

Observation: Courts have held that standstill agreements are appropriate and enforceable, and that directors do not violate their fiduciary duties to the stockholders by entering into and maintaining such standstill agreements. *See, e.g. Enterra Corp. v. SGS Associates*, 600 F. Supp. 678 (E.D. Pa. 1985) (because the standstill agreement served valid corporate purposes, the directors did not violate their fiduciary duty in refusing to submit a bid to the stockholders and the bidder was bound by the terms of the standstill agreement); *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585 (Del.Ch.), *aff'd*, 535 A.2d 1334 (Del.1987) (amended standstill agreement between Newmont and Gold Fields was reasonable in response to Ivanhoe's takeover threats); *West Point-Pepperell, Inc. v. J.P. Stevens & Co.*, 542 A.2d 770 (Del.Ch.1988)., *appeal refused*, 540 A.2d 1089 (Del.1988) (board's insistence that bidder sign confidentiality and standstill agreement in order to obtain company information was not an indication that board preferred another bidder contrary to the interests of the stockholders). Courts have looked unfavorably on standstill agreements with voting provisions that seem to entrench management by requiring the stockholder to vote in accordance with management's suggestions. *See, e.g. Lennane v. ASK Computer Systems, Inc.*, Fed. Sec. L. Rep. (CCH) 95,674 (Del.Ch.1990) (found this type of provision "deeply troubling"); *Gearhart Indus. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984) (standstill agreement with such a provision was considered "particularly suspicious").

3.3.5 Enforceability Of Standstill Agreement Against A "Jilted" Acquiror. A target company may enter into a confidentiality/standstill agreement with one potential acquiror and then subsequently agree to be acquired by another bidder. (A potential acquiror, of course, should try to limit the likelihood that this will occur by demanding a "no-shop" provision be included in the confidentiality/standstill agreement, as discussed in greater detail in Section 5 below.) The "jilted" acquiror may consider breaching the standstill agreement by making an unsolicited topping bid. However, the successful bidder probably will have obtained the target's agreement to enforce all confidentially and standstill agreements to which the target is a party.

Under the above scenario, the target's board will face difficult decisions. If the target does not seek to enforce the standstill, then the target will breach the agreement with the successful bidder. If the target seeks to enforce the standstill, however, then the target's stockholders may intervene to force the board to consider the topping bid. In either case the board is likely to become entangled in unpleasant litigation, based either on claims that the target breached its contractual obligations or that the board breached its fiduciary duties to the target's stockholders. For a discussion of the fiduciary duties of directors, see Section 7 below.

4. Getting To A Binding Agreement

4.1 Overview. Generally speaking, the most important step in "locking-up" a transaction is the execution of a definitive acquisition agreement that is legally binding upon the parties and that provides strong contractual protection against a break-up of the transaction. However, in many cases, the parties will choose first to enter into a letter of intent and thereafter proceed to negotiate and execute a definitive agreement. Below is a discussion of these two contractual steps.

4.2 Utilizing Letters Of Intent.

4.2.1 Overview. At some point during negotiations, the parties may reduce to writing the basic principles that must be negotiated in order to reach a deal. This document usually takes the form of a "term sheet" or "memorandum of deal points." Such a writing serves to keep the parties informed about those issues on which there has been closure and those issues on which the parties remain apart. However, once the parties believe that they have reached an agreement in principle on the major deal points, a strategic decision will have to be made as to whether it is better then for a letter of intent to be prepared and executed or for the parties to immediately proceed to negotiate and execute a definitive agreement. While the authors of this outline strongly favor the definitive agreement route, set forth below are the pros and cons of using letters of intent and the typical provisions negotiated with respect to a letter of intent.

4.2.2 Pros And Cons Of Using Letters Of Intent.

(i) Pros.

a. Presumably nails down the parties to the key deal points and gives direction to legal counsel, investment bankers, etc. in preparing a definitive agreement and completing due diligence.

b. Upon its execution, it allows the parties to immediately file under Hart-Scott-Rodino requirements and thus, starts the clock running for the waiting period.

c. Gives the acquiror an executed document that can be helpful to it in seeking sources for financing the deal.

d. Spells out the time-line for getting the deal done.

e. Acquiror may be able to obtain from the target company an exclusive right ("no-shop" provision) to negotiate a deal with the target for a specified period.

(ii) Cons.

a. Since, it is a "non-binding" agreement, no party is committed and thus, the deal is not locked-up. (However, the courts have recognized that a letter of intent can create a duty of the parties to negotiate in good faith.)

b. Major deal points can still surface once negotiations begin with respect to the definitive agreement. (Letters of intent are often premature because some "nitty gritty" issues are ignored or are intentionally skipped over until the definitive agreement is negotiated.)

c. Time spent in negotiating and preparing letter of intent could have been spent preparing a definitive agreement that is binding.

d. Risk that the letter of intent will be interpreted to create an obligation on the parties to do a deal notwithstanding a disclaimer that it is non-binding.

Observation: When the target company has publicly traded securities, it is especially difficult to see any real benefits in utilizing a letter of intent. The non-binding nature of most letters of intent makes the risks of losing the deal totally unacceptable to both parties. The target company has to worry about the risk of being "damaged goods" or adversely affecting its business if the deal falls apart after it has been publicly announced. And, while the would-be acquiror can seldom negotiate a letter of intent that has a binding commitment from the target to reimburse its for out-of-pocket costs or to pay it a "topping fee" if the target consummates a transaction with another party, the acquiror will have nothing to show for the lost transaction.

4.2.3 Non-Binding Provisions Contained In A Letter Of Intent.

Letters of intent attempt to outline the parties intention to proceed with the deal while expressly disclaiming any binding obligation on the parties to consummate a deal. Set forth below is an outline of some of the non-binding provisions that are often contained in a letter of intent.

(i) Parties To Agreement.

a. Acquiror.

b. Target Company.

c. Affiliates.

(ii) Transaction Structure.

a. Merger.

b. Sale of Assets.

c. Spin-off.

d. Other.

(iii) Form Of Consideration.

a. Cash Consideration.

b. Non-Cash Consideration.

- Equity Securities.
- Debt Issuance.
- Assumption of Debt.

c. Combination.

(iv) Special Terms For The Calculation Of The Amount Of Consideration.

a. Contingent Payout (Earn Out).

b. Post-Closing Adjustment to Price.

- Post-Closing Audit.
- Adjustment Formula.
- Means of Adjustment.

c. Adjustment to Exchange Ratio Due to Changes in Market Value of Securities Prior to Closing ("caps," "floors," etc.).

d. Escrow Arrangement to Cover Indemnification Obligations or Post-Closing Price Adjustments.

(v) Lock-Up Requirements.

a. Stock option granted by the target company.

b. Stock option granted by the major stockholders.

c. Voting agreement (grant of a proxy) executed by the major stockholders.

d. No-shop provision.

e. Board of Directors' commitment to recommend the transaction.

(vi) Conditions to Closing.

a. Tax Free Treatment.

b. Pooling Treatment.

c. Third-party Consents.

d. Financing Obtained.

4.2.4 Binding Provisions Contained In Letters Of Intent While non-binding as to the proposed deal, a letter of intent will often contain a few provisions that are binding. Set forth below are some of the typical binding provisions contained in a letter of intent.

(i) "No-Shop" Covenant - Exclusivity Period For Negotiating A Deal.

(ii) Joint Control Of Public Announcements.

(iii) Confidentiality Agreement (if there is no separate agreement).

(iv) Commitment Of Each Party To Bear Its Own Costs.

(v) Bust-Up Fee For Acquiror.

4.2.5 Express Disclaimer That The Letter Is A Binding Agreement Or A Commitment To Continue Negotiations Except For Items Described In Section 4.2.4.

4.3 The Definitive Agreement.

4.3.1 Overview. The negotiation and drafting of the provisions of a definitive agreement will be fundamental in protecting the corporate deal. However, the parties will each have separate reasons for wanting certain "outs" in the agreement that protect their respective interests. The scope and nature of covenants, representations and warranties, conditions to closing and termination rights will be heavily negotiated in the context of protecting the corporate deal. Furthermore, mechanisms for adjusting exchange ratios will have an affect on how tightly a deal is locked-up. And, of course, the fiduciary duties of the directors of the target company will impact the manner in which certain provisions are negotiated and drafted. Set forth below is a discussion of the key issues that will be considered in preparing a definitive agreement.

4.3.2 Representations and Warranties Of The Target Company. Representations and warranties of the target company are essential in seeking to make sure that the acquiror is getting exactly what it bargained for. The primary purpose behind these representations and warranties is to draw a clear (and sometimes detailed) written picture of the target company. They can be stated in the affirmative (e.g., "the target company owns all the patents, copyrights and trademarks listed on Schedule 1 free and clear of liens, encumbrances and other restrictions") or in the negative (e.g., "the target company has no pending lawsuits against it except as set forth on Schedule 2). In either case, they should be tailor made to the specific deal and the target company.

Representations and warranties are crafted to work together with (i) due diligence efforts and (ii) the covenants and conditions to closing contained in the definitive agreement. In the first place, the closing of the proposed transaction will be conditioned on the representations and warranties being true and correct not only on the execution date of agreement but also the closing date. This "bring down" requirement to the closing date offers the acquiror an opportunity to complete and otherwise continue its due diligence between the execution date and the closing date. In fact, the short-comings of conducting a limited due diligence effort during the negotiation period can be addressed by the acquiror. By way of illustration, a representation and warranty might reveal that the target company has failed in the past to take certain actions that if not addressed, could adversely affect its business. In those situations, the target company would be required to covenant that it will remedy the problem prior to closing (e.g., "the target company covenants that on or prior to closing, it shall file all past-due franchise tax forms and franchise taxes for those states identified on Schedule 3").

Observation. In the context of protecting a proposed corporate deal, the acquiror and the selling company have opposite positions when it comes the negotiation

and drafting of the seller's representations and warranties. Naturally, the acquiror wants them to be very detailed and tight so it can get out of the deal if the target company turns out to be different that the seller represented. On the other hand, the target company does not want the representations and warranties to be so unreasonable that they can be easily tripped thereby allowing the acquiror an unmerited exit from the deal. Indeed, an immaterial defect in a representation should not be grounds for terminating a deal. In seeking to protect against such a result, a seller will seek to limit the scope of its representations and warranties. The two most common methods for achieving that objective are the following:

(i) Materiality Qualifications. The primary method for limiting the scope of representations and warranties is to negotiate a "materiality" standard. By way of illustration, it is significantly different for a seller to represent that it has "all licenses and permits for conducting its business" as opposed to representing that it has "all licenses and permits that are material for conducting its business." Likewise, it is better to represent that the seller is qualified and in good standing as a foreign corporation in all jurisdictions where qualification is required "except for those jurisdictions where the failure to be so qualified will not have material adverse effect" than to give an outright representation with no such limitation on its scope. From a practical standpoint, a materiality standard is purely a matter of negotiation between the parties with respect to each respective representation. Often, the parties will conclude that a specific dollar threshold should be used in some representations rather than the term "material."

(ii) Knowledge Qualifications. Another aim of the target company in negotiating representations and warranties is to limit certain ones to the actual knowledge of the target company. Thus, a representation about pending litigation would be drafted along these lines: "the company has no pending litigation against it except as described on Schedule 1 or to the company's knowledge, no litigation has been threatened against it." The target company will want the "knowledge" requirement to mean the actual knowledge of executive management or perhaps, in the case of the sale of specific operations, the knowledge of the managers of those operations. In accepting a knowledge qualifier, the acquiror will insist that the representation and warranty contain a diligence representation (e.g., "after reasonable inquiry, the executive officers have no knowledge of any threatened litigation against the company"). By limiting a representation to a knowledge requirement, the acquiror is accepting the risk that the underlying representation may turn out to be false.

Perhaps the most negotiated "out" is the representation and warranty that since the date of the most recent audited financial statements, there has been no "material adverse change" in the company. This representation is always required to be "brought down" to the closing date. The purpose is to allow the acquiror to walk if the target company has suffered some major problem during the interim period between the execution date of the definitive agreement and the closing date. This material adverse change clause (commonly called the "MAC Clause") typically relates to changes in the financial condition or business operations of the target company. However, some acquirors will also seek to include changes in the "business prospects" of the target company. This is usually a hotly debated issue. From the authors' experience, it is seldom that a selling company will agree to a MAC Clause that covers business prospects largely because of the uncertainty of its scope and meaning.

In summary, representations and warranties must be carefully crafted to assure that they are reasonable in scope. That is why so much time is spent in negotiating representations and warranties. The nuances of the language used in representations and warranties require careful study, otherwise there may be an inadvertent violation of such representations and warranties.

4.3.3 Covenants. A definitive agreement will contain a covenant section that spells out certain obligations that the target company and the acquiror must perform between the execution date of the definitive agreement and the closing date. A breach of a covenant will give grounds for an action for damages plus it will serve as an out to the agreement because it will be a failed condition. Thus, the parties should exercise caution when agreeing to covenants. Some common covenants are the following (i) covenants to operate the business in the normal course of business, (ii) covenants restricting the sale of assets and securities or the creation of debt, and (iii) covenants to obtain all third-party consents necessary to consummate the transaction. Section 5 below discusses covenants designed to lock-up a transaction such as stock options, "crown jewel" options and "no-shop" clauses.

4.3.4 Conditions To Closing. Each party to a pending acquisition transaction will condition its obligation to close the deal on certain conditions having been satisfied or met on or prior to the closing. Closing conditions normally require the following actions to have been completed prior to closing: (i) all necessary third-party consents (including regulatory approvals) to the transaction having been obtained and (ii) all necessary stockholder approvals having been obtained. In addition, many transactions will be conditioned on the delivery of third-party opinions such as fairness opinions from investment banking firms, tax and corporate legal opinions from legal counsel and accounting opinions from independent accounting firms.

Observation. In seeking to protect a corporate acquisition, each party to the transaction must be very comfortable with the closing conditions before entering into the definitive agreement. The parties should have reasonable grounds for believing that the conditions can be satisfied. This means that the ability to obtain required third-party consents and opinions must be carefully checked out.

As already discussed in Section 4.3.2 above, a closing will normally be conditioned on the representations and warranties being true and correct as of the closing date. In particular, there must have been no material adverse changes in the target under the provisions of the MAC clauses. A closing will typically be conditioned on no material litigation being filed between the signing of the definitive agreement and the closing date. The difficulty with this condition is getting the parties to agree on what litigation should be considered grounds for aborting a pending transaction. Obviously, it makes no sense to condition the closing on there being no litigation filed after the execution of the definitive agreement. On the other hand, it is difficult to argue against a condition that is based on litigation of any kind that produces an injunction or restraining order. The negotiation of this provision should be crafted to the specific circumstances. Of course, the bargaining power of the respective parties will ultimately determine the scope of such a condition.

4.3.5 Purchase Price Adjustments. When the purchase price is all cash, the market price of the acquiror's stock is irrelevant to the deal. However, when the acquiror's stock is the currency for the acquisition, problems can arise. Indeed, another obstacle in getting a stock-for-stock transaction closed involves the risks of major fluctuations in the price of the acquiror's shares in the stock market between the signing of the definitive agreement and the closing date. In view of these risks, sometimes an acquiror and the target company will negotiate an exchange ratio that is aimed at protecting against major market fluctuations in the price of the acquiror's shares. Below is a discussion of the two most common methods for establishing an exchange ratio and how the parties will sometimes address market fluctuation risks.

A. Fixed Exchange Ratio. Less than majority of stock-for-stock transactions still use a negotiated fixed exchange ratio (e.g., 1 share of common stock of the acquiror for 1 share of common stock of the target company) in establishing the acquisition price. However, in the case of "merger of equals," a fixed exchange rate is commonly the

pricing mechanism that is adopted. This is the simplest and cleanest approach in working out a stock exchange ratio. But by doing this, the parties accept the market risks of changes in the stock price of the acquiror's shares prior to closing. This means that the dollar value of the acquiror's shares exchanged for shares of the target company can substantially increase or decrease by the time of closing. For instance, taking the above 1 to 1 exchange ratio example, the shareholders of the target company will receive $100 of cash equivalent value if the market price of one share of the acquiror is $100 at the time the definitive agreement is executed and it remains at $100 through the closing. On the other hand, if the price drops 30% to $70 by the closing date, the target company's shareholders will (based on market prices) receive much less in cash equivalent value for their shares. In addition, the premium that the acquiror originally contemplated paying for the target company's shares will likely have disappeared, making the deal much less attractive to the target company. This result can adversely affect the ability of the target company to obtain the needed shareholder vote of approval and might even invite competing bidders.

B. Floating Exchange Ratio. A floating exchange ratio is an alternative pricing mechanism that is utilized to help assure the target company shareholders that at the closing, they will receive acquiror shares having a cash value substantially equivalent to the value of the target company's shares that was agreed to by the parties when the definitive agreement was signed. Under a floating exchange ratio, the acquiror and the target company must negotiate a fair value amount for a share of the target company. The exchange ratio is then established as a fraction in which the fair value amount is the numerator and the price of a share of the acquiror in the stock market (established within an agreed to number of days prior to the closing) is the denominator. Under this formula, the exchange ratio in essence floats until a date near the closing when it is fixed based on the then market price of share of the acquiror.

By way of illustration, assuming that a transaction had closed on the signing date of the definitive agreement, the exchange ratio would have been 1 to 1 if the fair value amount of a target share had been set at $50 and if the stock market price for a share of the acquiror was then also $50. But, if the market price for a share of the acquiror had instead fallen 50% to $25 by the time of the closing, the exchange ratio would have been adjusted to 2 shares of the acquiror for 1 share of the target. Thus the shareholders of the target company would have still received $50 of cash equivalent value. Of course, under that scenario, the dilution suffered by the existing shareholders of the acquiror would be very detrimental to them. On the other hand, if by the time of the closing, the market price of a share of the acquiror had risen to $100, the ratio would then have been .5 of a share of the acquiror for 1 share of the target company. In that case, the target shareholders would be concerned that they had been short-changed because the increase in price of shares of the acquiror was due to unusual market speculation or conditions.

In view of the above illustrations, the acquiror and the target company can be exposed to substantial risks in using a floating exchange ratio formula. To protect against such risks, the parties will typically establish a "collar" around the floating exchange ratio formula whereby a fluctuation (up or down) in the price of the acquiror's shares will be acceptable so long as it stays within an agreed range on either side of a specified price amount. For example, the range would be $45 to $55 if the parties agreed to fluctuations of 10% above and below a strike price of $50. However, if the price fluctuation is outside the agreed to collar, a different pricing formula kicks in to provide for more or less shares to the target shareholders as the case may be. While the parties often agree to a fixed exchange ratio as the new pricing mechanism, many transactions adopt very complex mathematical formulas for establishing the new exchange ratio. Because of the uncertainty of how great the exchange ratio adjustment will be to account for a major price fluctuation, the parties often agree to "floors" that assure a minimum number of shares will be issued to the target's shareholders and

"ceilings" that assure the acquiror that the number of shares to be issued by it is capped at a specific number.

Another alternative for protecting against price fluctuations is for a target company to negotiate "walk away" rights if the price of acquiror's shares drops substantially below an agreed to price. While this mechanism can be stand alone, it will often be triggered if the price fluctuation drops below the floor that is coupled with a collar. Of course, "walk-away" rights run counter to the objective of protecting the corporate deal. For that reason, "walk away" rights are always conditioned on <u>major</u> price changes. The concept behind "walk-away" rights is that the decline in the acquiror's share price is so significant that something catastrophic must have occurred with the acquiror. In order to make sure the decline is not just an industry issue, walk-away rights are sometimes conditioned on the price drop being greater than the decline experienced by the industry peer group during the same period. In agreeing to "walk away" rights, an acquiror may request "topping out" rights pursuant to which it can, at its option, add additional consideration to get back to an acceptable price level which will probably be the "floor."

5. Locking-Up the Target Contractually

5.1 <u>General</u>. An acquiring party that enters into an acquisition agreement with a target obviously wants to ensure that the transaction is consummated. However, as described below under Section 7 "Fiduciary Duties of the Board of Directors", the board of directors of the target has certain fiduciary duties that it must fulfill in connection with such a transaction, including, in the context of a sale of control of the target, a duty to maximize shareholder value. If the board of directors of the target does not fulfill its fiduciary duties in connection with the contemplated transaction, the transaction may be enjoined, denying the acquiring party the benefits of the transaction, and, potentially, leaving the acquiring party with no way to recover the expenses it incurred in pursuing the transaction. Accordingly, it is in the best interest of the acquiring party, as well as the target, to ensure that the board's conduct fulfills its fiduciary duties.

5.1.1 <u>Auction of Target</u>. The duty to maximize shareholder value presents a difficult problem for both the target and the acquiring party. In theory, the most effective way for the board of directors of a target to maximize shareholder value would be to conduct a <u>public</u> auction of the target, with the highest bidder being the successful acquiring party. Few, if any, targets actually conduct a public auction.

Instead, a target and its investment bankers may conduct a "controlled" or "private" auction. In such a procedure, the target and its investment bankers typically set up a data room containing certain public and non-public information about the target, the target's investment bankers contact strategic and financial buyers who they believe might be interested in acquiring the target, the potential acquiring parties are granted access to the data room, and a bidding procedure is conducted pursuant to which each interested potential acquiring party submits its bid and a mark-up of the form of acquisition agreement prepared by the target's attorneys. There may be several additional rounds of bidding, along with "due diligence" meetings with management of the target, prior to the termination of the auction and the execution and delivery of a definitive agreement.

Short of a controlled auction, the target's investment bankers may "canvas the market" by contacting potential strategic and financial buyers to simply gauge their interest in pursuing a transaction. If any such persons indicate an interest, certain public and non-public information may be provided to the potential acquiring party. Discussions and negotiations may then ensue. Sometimes, however, targets do not conduct any form of auction, and no canvas of the market is performed, prior to executing a definitive agreement providing for the sale of the target.

The route chosen by the board of directors of a target may be affected the way in which the transaction develops. For example, the board may not have made a decision to sell the target; instead, they may be seeking "strategic alternatives" or exploring alternatives to maximize shareholder value (which may or may not involve the sale of the target), or may not be considering any alternatives at all, when it receives an indication of interest from a potential acquiring party. In such a scenario, the acquiring party and the target may proceed to negotiate a mutually beneficial transaction that results in the board of directors of the target deciding to sell the target. A controlled auction may not be possible under those circumstances; a canvasing of the market may be the best option available under those circumstances.

One important consideration for the board of directors of a target: There are risks associated with putting your company up for sale where no definitive agreement has been signed and, accordingly, no one is committed to buy. See Section 2 "Avoiding Premature Disclosure of the Deal" above. An auction, even if controlled, or a market canvas could have the effect of announcing to the world that the target is for sale.

5.1.2 Acquiring The Target Without An Auction. Few potential acquiring parties, if any, would be willing to expend the resources necessary to structure and pursue a transaction where no auction has been conducted, only to find that, having negotiated the definitive terms of a transaction, the target is not going to enter into a definitive agreement and is, instead, now going to subject the acquiring party's "bid" to a public bidding contest. The acquiring party does not want the target to use its "bid" to obtain other, possibly better, offers from third parties, especially where the acquiring party believes that it has put its "best offer" on the table. Having negotiated its deal, the acquiring party does not want to engage in a second, possibly extended, round of bidding with respect to the target. The reasons are obvious: an auction increases the risk that the acquiring party will not, in fact, be the successful bidder, and such an auction would likely result in the acquiring party paying a higher price for the target should it be the successful bidder. Accordingly, where no auction is being conducted, a potential acquiring part will likely insist on the execution of a definitive agreement and, absent such an agreement, there is no "bid" for the target by the acquiring party.

At the outset, an acquiring party has two seemingly incompatible goals: (1) a private negotiation followed by (2) a binding, enforceable agreement that forecloses the possibility of interlopers. In the absence of an auction or canvasing of the market, the acquiring party may achieve the first goal and obtain a definitive acquisition agreement; however, by achieving the first goal, the acquiring party will not attain the second goal. In this regard, targets typically demand certain "fiduciary outs" that permit them to entertain other offers. In other words, the mere existence of an definitive agreement does NOT preclude a third party bidder from making an offer to acquire the target and, in fact, effecting such acquisition. Where an auction or market canvas is conducted, obviously, the first goal is not met. That does not mean, however, that the second goal is met; fiduciary outs are still an issue.

Acquiring parties are not completely without protection, though. Acquiring parties typically demand that the definitive documentation contain certain provisions that limit the flexibility of the target and compensate the acquiring party for its efforts in the event the acquiring party loses the deal. In fact, these protections are usually a condition to the acquiring party entering into a definitive agreement. Yet, there remains the issue as to whether the protections may be granted consistent with the board fulfilling its fiduciary duties.

5.2 Governing Law. Most of the cases dealing with the duty of directors in connection with mergers and acquisitions and acquiring party protections involve Delaware companies and, accordingly, have been decided by Delaware courts under Delaware law. This outline, therefore, focuses on Delaware cases and statutory law. In transactions involving the law of states other

than Delaware, practitioners and courts frequently look to Delaware for guidance. Indeed, it is sometimes difficult to get practitioners to consider any law other than Delaware no matter how appropriate such consideration might be. Given the differences in state law in this area, and/or the lack of controlling precedent, counsel may be willing to be more aggressive in this area when dealing with the law of a state other than Delaware. In addition, some states allow the consideration of constituencies other than stockholders in connection with the approval of mergers and acquisitions. These statutes may very well impact the board's flexibility and obligations. Finally, in theory, the same duties apply to directors of private, as well as public, companies; however, existing case law usually, if not always, involves public companies. As a practical matter, the fiduciary duty concerns (including those regarding maximizing shareholder value) that arise with respect to public companies usually do not arise, or do not rise to the same level, in transactions involving private companies.

5.3 Lockup Provisions In the Definitive Agreement. Below is a general discussion of the contractual provisions that are negotiated in a definitive agreement for the purpose of locking-up a deal. The fiduciary duties of directors in agreeing to such provisions are discussed in Section 7 below. Attached hereto as Exhibits C, D and E are sample forms of lock-up provisions.

5.3.1 No-Shop Provisions. These provisions typically prevent the target, its directors, officers, employees and representatives (*e.g.,* investment bankers) from soliciting other bids or providing information to, or entering into discussions or negotiations with, other potential bidders. As one would expect, these provisions are usually very broadly drafted, often providing that none of the enumerated persons may take any action to facilitate any other acquisition proposal or actions which may reasonably be expected to lead to an acquisition proposal. These provisions also, oftentimes, expressly call for the cessation of all discussions with third parties that may have been occurring simultaneously with the negotiations with the acquiring party. These provisions typically are subject to a "fiduciary out" (as described below under "Fiduciary Duties of the Board of Directors").

5.3.2 Restrictions on Board Action. The acquiring party will often insist on a provision that prohibits the target from endorsing or agreeing to endorse any third party acquisition proposal or withdrawing or modifying its recommendation as to the previously negotiated transaction with the acquiring party. In addition, these provisions prohibit the target from redeeming or waiving the effect of a poison pill that it may have in place or, where otherwise separately waivable, any control share acquisition statute, except in connection with the transaction with the acquiring party. These provisions typically are subject to a "fiduciary out" (as described below under Section 7 "Fiduciary Duties of the Board of Directors").

5.3.3 "Bust-Up" or "Topping Fees". These provisions typically require the target to pay to the acquiring party a specified amount (usually 1% - 3% of the transaction value to the stockholders), in cash, in the event the transaction with the acquiring party is abandoned as a result of another bid. Sometimes these provisions also provide for the payment by the target of the expenses incurred by the acquiring party in connection with the abandoned transaction; sometimes the expense reimbursement provisions are capped. Also, these provisions sometimes require the payment of such a fee to the acquiring party even if there exists no competing bid at the time the agreement with the acquiring party is terminated if the target effects a transaction with another party within a specified time period following such termination and the target had had discussions with the other party prior to such termination.

5.3.4 Termination Rights. Acquiring parties often insist that the definitive agreement provide that the acquiring party shall have the right to terminate the agreement and, where provided, obtain its bust-up or topping fee and expense reimbursement where the target breaches the no-shop or restrictions on board action provisions or where the board of directors takes action that would breach those provisions but for the presence of a

"fiduciary out". In addition, oftentimes the acquiring party will have a termination right (and right to fees) in the event the board of directors does not reaffirm its approval of its transaction with the acquiring party within a short period of time following a third party acquisition proposal. Also, acquiring parties are beginning to insist on provisions that require a target to terminate the agreement, thus triggering any deal-bust fees and expense reimbursement provisions, if the target exercises its fiduciary out or takes certain other specified actions inconsistent with the transaction with the acquiring party.

5.3.5 Options to Purchase Assets ("Crown Jewels") of Target. Acquiring parties sometimes insist on an agreement by the target to sell to the acquiring party certain highly desirable assets (hence the "crown jewel" reference) of the target in the event the transaction is abandoned. In that instance, the acquiring party obtains the most highly prized assets of the target, thus ensuring receipt of a significant portion of the anticipated benefits of the transaction by the acquiring party, and rendering the target less attractive to potential third party bidders.

5.3.6 Options to Purchase Shares of Target Granted by Target. Acquiring parties will sometimes insist that the target grant to the acquiring party an option to purchase shares of common stock of the target at the price to be paid in the contemplated transaction. The number of shares subject to the option is usually below 20% of the shares outstanding prior to the grant of the option, due to stock exchange restrictions. Such an option makes a transaction by a third party more expensive, as would be the case with a bust-up or topping fee, because a third party bidder will have to pay a higher price to acquire the shares purchased under the option (entitling the acquiring party to pocket the "spread"). Such an option also grants to the acquiring party the ability to acquire a significant block of shares in the event the acquiring party were to attempt to block a transaction with a third party bidder.

6. Locking-Up the Voting Power of the Target Contractually

6.1 Executive Officers, Directors and Major Stockholders. Acquiring parties will often ask that certain executive officers and directors who own shares of stock in the target, as well as any major stockholders that exercise a significant degree of control over the target, agree to "support" the contemplated transaction. Attached hereto as Exhibits D and E are sample forms of voting agreements and stock options.

6.2 Agreement to Support. The respective agreements of officers, directors and major stockholders to support the contemplated transaction will be evidenced by an agreement between such persons and the acquiring party, often called a "support" or "tender" agreement. Set forth below are typical provisions in a support requirement.

6.2.1 Tender Agreement. Where the contemplated transaction involves a tender offer by the acquiring party, the acquiring party will request that certain officers, directors and major stockholders agree to tender their shares in the tender offer. Usually, such persons are required to tender within a short period of time following the commencement of the tender offer. In the event another tender offer is made that is superior to the offer being made by the acquiring party, the officers, *etc.,* often have the right to withdraw their shares from the acquiring party's offer, provided certain conditions are met.

6.2.2 Agreement to Vote/Grant of Proxy. The acquiring party will typically request that the specified officers, directors and major stockholders agree to vote in favor of, or give a written consent in respect of, the merger agreement and grant to the acquiring party an irrevocable proxy enabling the acquiring party to act for such person in respect of those matters.

6.2.3 Transfer Restrictions. The support agreement will restrict the officer, director or major stockholder's ability to dispose of its shares of common stock in the target.

6.2.4 Stock Purchase Option. Acquiring parties often request that major stockholders grant to the acquiring party an option to purchase such stockholders' shares of common stock in the target. The exercise of the option may give the acquiring party sufficient voting or economic power to prevent a third party bidder from acquiring the target or, in the event such third party bidder acquires the target, permit the acquiring party to earn the spread between the exercise price and the price paid by the third party bidder in the acquisition. The following are the primary issues that may arise in connection with the grant of such an option.

(i) Whether the acquiring party pays any consideration for the options and, if so, whether that consideration is offset against the exercise price.

(ii) Whether the acquiring party is entitled to the upside in the option in the event a competing bid is made and consummated.

(iii) Similar to an agreement to tender, in the event of a competing offer, whether the grantors of the options have the right to terminate the option and participate in the competing offer. If so, then the option is largely illusory.

(iv) Whether a board of directors may approve a transaction and fulfill its fiduciary duties when one of the principal terms of the transaction is the grant by a controlling stockholder to the acquiring party of an option to purchase its shares. In other words, does the fact that an acquiring party has the right, through the exercise of an option to acquire a controlling stake in the target and, therefore, block any competing offers, render any market check/fiduciary out meaningless? Along these lines, *see Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345 (Del. 1993), where, MAF would control approximately 34% of the outstanding stock of Technicolor through individual stock purchase agreements, a stock purchase option granted by Technicolor and shares already owned by MAF. "Taking this evidence into account, along with Technicolor's supermajority charter provision, requiring a shareholder vote of ninety-five percent of the outstanding shares for approval of a merger, the Chancellor found a probable 'lock-up' by MAF of Technicolor." *Id.* at 355 (citation omitted). However, "[t]he Court of Chancery concluded on remand that the MAF transaction was not 'locked up' by any device except its very high price." *Cinerama v. Technicolor Inc.*, 663 A.2d 1156, 1173 (Del. 1995).

6.2.5 No-Shop. Support agreements often contain the personal agreement of the executive officers, directors and major stockholders not to solicit any competing bids. These provisions are virtually identical to the restrictions placed on the target.

7. Fiduciary Duties of the Board of Directors

7.1 The Business Judgment Rule.

7.1.1 The Traditional Business Judgment Rule. "A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *see also* DEL. CODE ANN. tit. 8, § 141(a) (1997). The business judgment rule is an affirmation of the "managerial prerogatives of Delaware directors." *Aronson*, 473 A.2d at 812.

The rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.* (citation omitted); *accord*

Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360-61 (Del. 1993) ("*Technicolor I*"). Stated differently, the business judgment rule is more than a defense; it is a presumption that the directors have acted appropriately. *See generally*, *Technicolor I*, 634 A.2d at 361; *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). This presumption is valuable because "[a]bsent an abuse of discretion, [the directors'] judgment will be respected by the courts." *Aronson*, 473 A.2d at 812. In other words, "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Unocal*, 493 A.2d at 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (1971)). In fact, the burden of proof is on the party challenging the directors' decision to establish sufficient facts to rebut the presumption. *Aronson*, 473 A.2d at 812. The business judgment rule creates a similar presumption in most other states as well. *See* D. Block, S. Radin and N. Barton, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (Prentice Hall Law & Business, 4th Ed. 1993), pp. 12-14, footnotes 52-72.

It is important to note that while directors possess the power to manage the corporation, "[t]he existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders." *Aronson*, 473 A.2d at 811 (citation omitted). Specifically, in exercising their discretion, directors owe a duty of care and a duty of loyalty to the corporation's shareholders.

7.1.2 Requirements for Application of the Business Judgment Rule. In order for a director to be entitled to the presumptions of the business judgment rule, at least three basic requirements must be met:

- A decision must be made which is later challenged as breaching the fiduciary duty of the director.
- In reaching the decision, each director must have fulfilled (or not breached) his or her duty of care.
- In reaching the decision, each director must have fulfilled (or not breached) his or her duty of loyalty to the corporation.

Failure to meet any of the foregoing requirements results in an opportunity for the plaintiff to rebut the rule's presumption that decisions were made on an informed basis, in good faith, and in the best interests of the corporation, and the burden of proof is shifted from the plaintiff to the defendant director.

7.1.2.1 Decision. "[T]he business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act." *Aronson*, 473 A.2d at 813; *see also Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993) (citation omitted); *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 275 (2d Cir. 1986). Accordingly, the directors must make a decision or determination to act or refrain from acting. Ignoring a situation or failing to actually make a decision can result in loss of the protection of the rule for the directors involved. *See Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

7.1.2.2 Duty of Care. In order to invoke the rule's protection, "directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties." *Aronson*, 473 A.2d at 812; *see also Van Gorkom*, 488 A.2d at 872-73.

The duty of care turns in large measure on the process utilized by the board in reaching its decision. Prior to making a decision, directors must consider all relevant information and engage in appropriate deliberations. The issue for counsel frequently is to determine when the directors are sufficiently informed and when their decision-making process has been appropriately deliberative. In short, when have the directors done enough to satisfy their duty of care? This determination can be very fact specific and subjective.

Reliance on Professionals and Experts. The duty of care does not impose upon directors a requirement that they themselves be or become experts in the matters presented for their action. As a practical matter, directors often will have to rely on the advice and opinions of professionals and experts in coming to a decision. Indeed, Section 141(e) of the Delaware General Corporation Law ("DGCL") provides that directors

> shall . . . be fully protected in relying in good faith upon . . . information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation. DEL. CODE ANN. tit. 8, § 141(e) (1997).

It is not unusual and may even be customary for boards and special committees to retain outside advisors in connection with merger and acquisition transactions. Delaware courts have made it clear that not only must experts be selected with reasonable care, but the board or committee is also required to actively and directly oversee the experts in order to rely upon them. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989). And it is widely accepted that in order to meet this standard the advisor must be independent. Although past representation of the corporation will not give rise to disqualification *per se*, it is a circumstance which must be reviewed carefully. *See*, *In re Oracle Sec. Litig.*, 829 F.Supp. 1176, 1189-90 (N.D. Cal. 1993) (in-house attorney could not be relied upon in giving advice concerning settling litigation against officers of the corporation with whom he served); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978) (counsel to parent company could not give wholly independent advice because he was primarily interested in the parent company).

Similarly, investment bankers must be independent to be relied upon to give advice to a board of directors or a committee. *In re Tri-Star Pictures Litig.*, 634 A.2d 319, 323 (Del. 1993). Thus, the investment banker's compensation arrangement should be structured so as to avoid creating a question about independence.

Van Gorkom. The *Van Gorkom* decision provides some guidance in determining whether a board has met its duty of care. *Van Gorkom* arose out of the approval and recommendation of the board of directors of Trans Union of a cash-out merger. Without discussing the transaction with Trans Union's directors, Van Gorkom, Trans Union's Chairman and CEO, proposed to Jay Pritzker, a well-known corporate takeover specialist, a cash-out merger of Trans Union with a company controlled by Pritzker. Van Gorkom also proposed that the price of the Trans Union shares be $55 (a value which represented a significant premium over the historic trading range of Trans Union shares).

Shortly thereafter, Pritzker made an offer of $55 per share conditioned upon acceptance by the Trans Union board within three days.

Van Gorkom then called a special meeting of the board without disclosing the purpose of the meeting to the directors. Just prior to the board meeting, Van Gorkom informed senior management of the offer. Most of senior management reacted strongly against the offer. At the board meeting, Van Gorkom failed to inform the board that it was he, not Pritzker, who had proposed the $55 per share price.

The CFO had previously performed a brief preliminary study to determine the cash flow needed to service the debt of a management leveraged buy-out. However, he had expressly never calculated a fair price for the company or its entire stock.

No fairness opinion as to the valuation of the company was ever obtained. Therefore, the board of directors made no investigation, sought no advice from third persons and had no opinions to review with respect to the true value of the company. Nonetheless, after a very brief deliberation (about two hours), the board approved the merger agreement, without reading it.

The court found that the directors were not adequately informed about Van Gorkom's role in either the sale of the company or in establishing the price or intrinsic value of the company. *Van Gorkom,* 488 A.2d at 874. The court found that the directors were grossly negligent in approving the sale in a short meeting called without notice and without any emergency requiring them to act so quickly. *Id.*

The defendants claimed that the magnitude of the premium between the $55 offering price and Trans Union's current market price of $38 per share showed that the board's decision was an informed one. However, as the court stated, "[a] substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price." *Id.* at 875. Because the directors had no such other information, the court found that reliance on the market price was clearly faulty and, therefore, grossly negligent. *Id.* at 874.

Limiting Personal Liability of Directors. In response to *Van Gorkom*, the Delaware legislature enacted Section 102(b)(7) of the DGCL which permits a corporation to provide in its certificate of incorporation for the elimination of personal liability of directors to the corporation or its shareholders for monetary damages for breach of fiduciary duty. This section permits insulation from liability so long as the certificate of incorporation does not eliminate or limit liability resulting from:

(a) breach of the duty of loyalty;

(b) willful acts or acts not in good faith;

(c) unlawful dividend payments or unlawful stock purchase/redemption; and

(d) situations where the director receives an improper personal benefit.

This limitation on personal liability, however, does not eliminate the requirement that the board act with due care or prohibit courts from enjoining transactions where the board has not met that duty.

7.1.2.3 Duty of Loyalty. The business judgment rule assumes directors give their undivided loyalty to the corporation. When one or more directors have an interest in a decision made by them, the business judgment rule may not be available. In that circumstance, the burden of proof shifts to the board to show its decision was "entirely fair" to the corporation and its shareholders. In other words, the directors must prove that the transaction was the product of both fair dealing and fair price. *Mills Acquisition*, 559 A.2d at 1280. This standard is known as the "entire fairness test," and in the case of mergers and acquisitions, it means the court must review the entire transaction to determine whether or not it was fair to the corporation and its shareholders.

The more difficult issue is determining when the interest of a director in a transaction causes the entire board to lose the presumption of the business judgment rule. This issue was addressed in *Cinerama v. Technicolor Inc.*, 663 A.2d 1156 (Del. 1995) ("*Technicolor II*"), where the Delaware Supreme Court affirmed the Chancery Court's conclusion that the action of an entire board could be tainted and the business judgment rule not be available where:

(i) although less than a majority of directors had a material interest, those interested controlled or dominated the board; or

(ii) the interested directors failed to disclose their interest and a reasonable board member would have believed the existence of the material interest significant in evaluating the proposed transaction. *Id.* at 1168.

The Delaware legislature has provided a safe harbor for contracts and transactions involving an interested director. Section 144(a) of the DGCL provides that a contract or transaction in which a director has an interest is not void or voidable if:

(a) a director discloses any personal interest in a transaction to the board or committee and the board or committee authorizes the transaction by vote of a majority of the disinterested directors on the board or committee;

(b) a majority of the shareholders approve the transaction by good-faith vote and are also aware of the director's interest; or

(c) the transaction is fair to the corporation as of the time it was approved by the board or the shareholders. DEL. CODE ANN. tit. 8, § 144(a) (1997).

However, Section 144(a) of the DGCL does not address the issue of director liability or the availability of the business judgment rule under the circumstances outlined.

The duty of loyalty includes, as can be seen from the cases referred to above, the duty to disclose. The duty to disclose in turn requires an examination of materiality which is a condition to the duty to disclose. *See Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977). In the end, the entire determination is very fact specific and can present a real conundrum for practitioners.

7.1.3 Duties of Care and Loyalty and the Use of Special Committees. The Delaware Supreme Court has made it clear that a board's ability to discharge its duty of care is "materially enhanced" where a majority of the board consists of independent outside directors. *See Unocal*, 493 A.2d at 955; *Paramount Communications, Inc. v. Time*, 571 A.2d 1140, at 1154 (Del. 1989). The same result may be achieved where a majority of the board does not consist of independent or disinterested directors if authority to act is delegated to a special committee consisting solely of independent directors. *See Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1118-21 (Del. 1994). As noted by Chancellor Allen in *Kahn v. Tremont Corp.*, 18 Del. J. Corp. L. 723, 729-30 (Del. Ch. Aug. 21, 1992) (citation omitted):

> The device of the special committee of the board is one that has in recent years come to be widely employed. . . . In some instances, it appears to have served effectively to permit the board to function in the corporation's interest, even though senior management was adverse to the corporation with respect to the transaction in question. In other instances the form of an independent committee seemed to mask an ineffectual or corrupted effort. . . . Whether the operation of a special committee will be deemed to qualify a transaction for the ordinary presumption that attaches to the action of a disinterested board should, in my opinion, turn on a specific evaluation of the facts of the case.

Even when most of the board is independent, it may make sense to delegate some of the functions in connection with merger and acquisition transactions to an independent committee. *Hanson Trust*, 781 F.2d at 277; *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n. 7 (Del. 1983). But, in either case, the independent board or the independent committee must be active in the process. *See Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1245 (Del. Ch. 1988); *Mills Acquisition*, 559 A.2d at 1281; *Hanson Trust*, 781 F.2d at 276. Finally, a board may choose not to designate a special committee for fear that a plaintiff could argue that such a designation is evidence that the board, as a whole, lacked the independence necessary to act with respect to the matter before it.

7.2 Board Conduct and Corporate Control.

7.2.1 Contests for Corporate Control; Enhanced Scrutiny. A number of the early cases regarding board conduct in connection with a sale of the company arose in the context of contests for corporate control. In a contest for control of the company, Delaware courts will not automatically apply the business judgment rule but will first review the board’s action and process under a standard of “enhanced scrutiny.” *See, e.g.*, *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994). The same standard is applied to adoption of defensive measures. *Unocal*, 493 A.2d at 954.

Unocal. *Unocal* is the landmark case involving “enhanced scrutiny” in the context of defensive measures or actions which might inhibit future takeover efforts. The board of directors of Unocal, in response to the commencement of a two-tier "front loaded" cash tender offer by Mesa, the owner of 13% of Unocal's stock, decided that is should institute a stock repurchase plan, excluding Mesa.

The *Unocal* court adopted a two-prong test for determining whether or not the business judgment rule applies to defensive measures adopted by a board. First, were there reasonable grounds for the board to conclude a danger to corporate policy existed? Second, was the defensive measure taken reasonable in relation to the threat posed? *Id*. at 955. This same test was discussed in *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995), where the court citing *Unocal* said:

Consequently, in such situations, before the board is accorded the protection of the business judgment rule, and that rule's concomitant placement of the burden to rebut its presumption on the plaintiff, the board must carry its own initial two-part burden.

If the board carries its burden on each of these issues, then it is entitled to the benefits and protection of the business judgment rule. *Unocal*, 493 A.2d at 954-56.

The first prong of the test is satisfied "by showing good faith and reasonable investigation." *Unocal*, 493 A.2d at 955 (quoting *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. 1964)). "Furthermore, such proof is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards." *Unocal*, 493 A.2d at 955. With respect to the second prong, "[a] corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available." *Id.* "[D]efensive measures which are either preclusive or coercive are included within the common law definition of draconian" and therefore exceed the proper proportionality. *Unitrin*, 651 A.2d at 1387-88.

7.2.2 Sale of Control; Stock for Stock/Strategic Mergers. The responsibilities of a board of directors in the context of a sale of corporate control have been the subject of a significant amount of litigation. The duties of the board in this context can be generally illustrated by a review of the *Revlon*, *Time* and *QVC* cases.

7.2.2.1 *Revlon*. The *Revlon* decision arose out of a battle for corporate control of Revlon, Inc. In 1985, Pantry Pride expressed its interest in acquiring Revlon to Michel Bergerac, Revlon's CEO and Chairman of the Board. Bergerac was adamantly opposed to such a transaction with Pantry Pride and eventually agreed to a leveraged buyout by Forstmann Little. The agreement with Forstmann included a lock-up option, no-shop provision, and cancellation fee in favor of Forstmann. Pantry Pride made an initial hostile lender offer at $47.50 per common share and subsequently entered bids of $50 per share, $53 per share, and a final bid of $56.25 per share. Forstmann countered with a final bid of $57.25 per share. Revlon remained committed to its agreement with Forstmann.

The court determined that once a sale or break-up of the company became inevitable, the board's duty was to maximize shareholder value. *Revlon*, 506 A.2d at 182.

> [w]hen Pantry Pride increased its offer to $50 per share, and then to $53 per share, it became apparent to all that a break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. ... The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

In addition, the court held that when the "original threat posed by Pantry Pride--the break-up of the company--had become a reality . . . . [s]elective

dealing to fend off a hostile but determined bidder was no longer a proper objective." *Id.*

The *Revlon* court also indicated that certain measures, such as break-up fees, no-shop provisions, lock-up clauses and similar provisions are not permissible when they have the effect of ending the auction or foreclosing bidding and thereby operate to the detriment of the shareholders. *Id.* at 183-84.

7.2.2.2 *Time*. In *Time,* 571 A.2d 1140, Time entered into a strategic stock merger agreement with Warner Communications, Inc. in which Warner shareholders would own approximately 62% of the common stock of the surviving entity. When Paramount subsequently made an unsolicited tender offer for 51% of Time's common stock at a significant premium to the market price and announced the tender offer would be followed by a back-end merger for cash and securities, Time restructured its merger with Warner for an immediate friendly tender offer for 54% of Warner, to be followed by a later purchase of the remainder of Warner. As restructured, the Warner transaction did not require approval of the Time shareholders.

Consideration by Time's executive board of expansion into the entertainment industry began as early as 1983 and 1984. It was not until 1987 that a meeting between Time and Warner took place. Although Time had considered a number of other possible merger candidates, Warner stood out as a favorite because its businesses were highly compatible with Time's long-term strategy of expansion into the music and film business. Ultimately, in 1989, Time's board approved a stock-for-stock merger with Warner. At the same time, the board adopted a number of defensive tactics and entered into a no-shop agreement with Warner.

Later in 1989, Paramount made a surprise bid for Time's stock. Although Paramount proposed an all-cash offer to purchase Time's stock at $200 per share (as opposed to Warner's stock-for-stock offer), the "Time board maintained that the Warner transaction offered a greater long-term value for the stockholders and, unlike Paramount's offer, did not pose a threat to Time's survival and its 'culture.'" *Id.* at 1149.

The Delaware Supreme Court held there was no evidence that Time's board had triggered its *Revlon* duties because the break-up of Time had not been made inevitable as was the case in *Revlon*. *Id.* at 1150. The corporation neither initiated an active bidding process to sell itself nor abandoned its long-term strategy. In *Revlon*, the board responded to Pantry Pride's offer by contemplating a sale of assets. Thus, the court imposed upon the board a duty to maximize shareholder value. However, if "the board's reaction to a hostile tender offer is found to constitute only a defensive response and not an abandonment of the corporation's continued existence [as was the case in *Time*], Revlon duties are not triggered, though Unocal duties attach." *Id.* Furthermore, "[t]he adoption of structural safety devices alone does not trigger *Revlon*. Rather . . . such devices are properly subject to a *Unocal* analysis." *Id.* at 1151.

7.2.2.3 *QVC*. *QVC* provided the Delaware Supreme Court with the opportunity to clarify both *Revlon* and the impact of *Time*, which permitted a corporation to rely on strategic objectives to avoid unwanted suitors, on *Revlon*. In so doing, the court provided an extended discussion of the importance of the sale of control and the standard of review that will apply to the conduct of a board of directors in the context of a sale of control. In addition, the court affirmed that improper defensive measures will be held invalid and unenforceable.

Background. This case arose out of the contest between Viacom Inc. and QVC Network Inc. for Paramount Communications Inc. Paramount was a New York Stock Exchange listed company and a majority of its stock was "held by numerous unaffiliated investors". *QVC*, 637 A.2d at 37. Viacom was controlled by Sumner Redstone. *Id.* at 38.

Paramount had a "goal of strategic expansion" that involved the consideration of acquisitions or mergers. *Id.* In the summer of 1993, "serious negotiations" commenced regarding the combination of Viacom and Paramount. *Id.* The Paramount board was informed of the negotiations and received certain financial information from Paramount's financial advisor on September 9, 1993. *Id.* at 39.

The Paramount board met on September 12, 1993 and approved a merger agreement (the "Original Merger Agreement") pursuant to which Paramount would be merged into Viacom, with each outstanding share of Paramount common stock being converted into specified fractions of shares of voting and non-voting common stock of Viacom and cash. The Paramount Board would also amend its "poison pill" Rights Agreement to exempt the merger. *Id.* The Viacom transaction contained three defensive measures that were considered by the court: the no-shop and termination fee provisions in the Original Merger Agreement and an option to acquire shares of Paramount stock representing just under 20% of the outstanding shares. The court termed the option "the most significant deterrent device" of the defensive measures. *Id.*

The no-shop provision prohibited Paramount from soliciting, encouraging, discussing, negotiating, or endorsing any competing transaction, except in response to an "unsolicited written, bona fide proposal, which is not subject to any material contingencies relating to financing" and the board determines that, in order to comply with its fiduciary duties, such action is necessary. *Id.* The termination fee provision required the payment of a termination fee of $100 million if "(a) Paramount terminated the Original Merger Agreement because of a competing transaction; (b) Paramount's stockholders did not approve the merger; or (c) the Paramount Board recommended a competing transaction." *Id.* The option was exercisable upon the occurrence of any of the events upon which the termination fee would be payable. The option permitted Viacom to pay for the shares with a "senior subordinated note of questionable marketability instead of cash, thereby avoiding the need to raise the $1.6 billion purchase price" and allowed Viacom to, in effect, put the option to Paramount in exchange for the spread between the exercise price and the market price for Paramount common stock. *Id.*

QVC then attempted to negotiate a transaction with Paramount. Discussions finally commenced and proceeded slowly. QVC then publicly announced a hostile cash tender offer for 51% of Paramount, to be followed by a second-step merger pursuant to which the outstanding shares of Paramount common stock would be converted into shares of QVC common stock. *Id.* at 40. In response to QVC's higher bid, Viacom and Paramount entered into negotiations to alter the structure of their transaction and increase the consideration payable thereunder. Although this presented the Paramount board with the opportunity to negotiate a "new deal" with Viacom, the court found that the amended merger agreement was "essentially the same as the Original Merger Agreement", although it provided "more consideration to the Paramount stockholders and somewhat more flexibility to the Paramount Board ... ." *Id.*

The Paramount board met on November 15, 1993 to consider QVC's latest offer and determined that such offer was not in the best interests of Paramount's stockholders, purportedly because QVC's bid was "excessively conditional". *Id.* at 41. QVC sought, and obtained, a preliminary injunction regarding Paramount's defensive measures.

Standard of Review. The court noted that "[u]nder normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled." *Id.* at 42 (citing *Aronson*, 473 A.2d at 812).

> Nevertheless, there are rare situations which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable. The decisions of this Court have clearly established the circumstances where such enhanced scrutiny will be applied. ... The case at bar implicates two such circumstances: (1) the approval of a transaction resulting in a sale of control, and (2) the adoption of defensive measures in response to a threat to corporate control.

Id. (citations omitted).

In connection with a sale of control, directors

> have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.

Id. at 43.

As the court stated, quoting *Macmillan*,

> When *Revlon* duties devolve upon directors, this Court will continue to exact an enhanced judicial scrutiny at the threshold, as in *Unocal*, before the normal presumptions of the business judgment rule will apply.

Id. at 45 (footnotes and citations omitted).

Enhanced scrutiny will involve:

> (a) a judicial determination regarding the adequacy of the decision making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.

Id.

However, under enhanced scrutiny, "courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision

was, on balance, within a range of reasonableness." *Id.* at 45. (citations omitted).

The Importance of Control; *Revlon* and *Time*. In its opinion, the *QVC* court devoted a significant amount of attention to the importance of control and, therefore, the reason for enhanced scrutiny. As a result of the Paramount-Viacom transaction, the Paramount stockholders would have a minority equity interest in Viacom and, accordingly, control of Paramount would pass from a "fluid aggregation of unaffiliated stockholders" to Redstone.[1] In effect, the sale of control overrides a corporation's strategic objectives: "Irrespective of the present Paramount Board's vision of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision." *Id.* at 43. In addition, "the change in control would supplant the authority of the current Paramount Board to continue to hold and implement their strategic vision in any meaningful way. *Id.* at 50.

The defendants in QVC had argued that enhanced scrutiny was not appropriate "in the absence of a 'break-up' of the corporation." *Id.* at 46. Both *Revlon* and *Time* did use the term "break-up". However, the court found that the defendants had misinterpreted *Revlon* and *Time*. The court noted that a break-up is not necessary for *Revlon* duties to apply and cited several cases in which a change in corporate control gave rise to those duties. *Id.* With respect to *Time*, the court noted "that there was no change in control in the original stock-for-stock merger between Time and Warner because Time would be owned by a fluid aggregation of unaffiliated stockholders before and after the merger ... ." *Id.*

In effect, the court held that it was not setting a new standard in *QVC* or overruling anything in *Revlon* or *Time*, in spite of the significant discussion devoted to the importance of control; *QVC* was consistent with both of those cases. Accordingly, *QVC* reaffirms the holding in *Time*, that a stock for stock merger between two public companies will not necessarily constitute a change of control and thus will not necessarily trigger *Revlon* duties. *Id.* at 47. This is intuitive, for if the stock of both companies is widely dispersed, then control merely moves from one unaffiliated group of shareholders to another, notwithstanding that management of the surviving company may be quite different for some of the shareholders. But, at least where there will be a clear change of control, *Revlon* duties will apply and the requirement that the board maximize shareholder value cannot be avoided.

Breaches of Fiduciary Duty. The court found "that the Paramount directors' process was not reasonable, and the result achieved for the stockholders was not reasonable under the circumstances." *Id.* at 49. The court found that "[w]hen entering into the Original Merger Agreement, and thereafter, the Paramount Board clearly gave insufficient attention to the potential consequences of the defensive measures demanded by Viacom." *Id.* The court

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1. The court noted that

> there will be a controlling stockholder who will have the voting power to: (a) elect directors; (b) cause a break-up of the corporation; (c) merge it with another company; (d) cash-out the public stockholders; (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders' interests. *Id.* at 43.

noted the "unusual and potentially 'draconian' provisions" of the option arrangement. *Id.* "Because the [option] was not 'capped' to limit its maximum dollar value, it had the potential to reach (and in this case did reach) unreasonable levels." *Id.* at 39. In addition, the termination fee, coupled with the option arrangement, "clearly made Paramount less attractive to other bidders". The no-shop provision "inhibited the Paramount Board's ability to negotiate with other potential bidders, particularly QVC which had already expressed an interest in Paramount". *Id.* at 49 (footnotes omitted). "Throughout the applicable time period . . ., QVC's interest in Paramount provided the **opportunity** for the Paramount Board to seek significantly higher value for the Paramount stockholders than that being offered by Viacom." *Id.* (emphasis in original). In addition,

> [t]he Paramount directors had the opportunity . . ., when the Original Merger Agreement was renegotiated, to take appropriate action to modify the improper defensive measures as well as to improve the economic terms of the Paramount-Viacom transaction. ... Nevertheless, the Paramount Board made no effort to eliminate or modify these counterproductive devices ... .

Id. at 50. Indeed, the court found no evidence in the record that Paramount sought to use "its newly-acquired leverage to eliminate or modify" those devices. *Id.* at 41.

Enforceability. Viacom argued that it had a "vested" right to the option and the no-shop provision, notwithstanding the conduct of the Paramount directors. The court found Viacom's argument "without merit". *Id.* at 50.

> This Court has found that those defensive measures were improperly designed to deter potential bidders, and that such measures do not meet the reasonableness test to which they must be subjected. The are consequently invalid and unenforceable under the facts of this case.

Id. at 50-51.

In discussing the no-shop provision, the court stated that the no-shop provision

> could not validly define or limit the fiduciary duties of the Paramount directors. To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. Despite the arguments of Paramount and Viacom to the contrary, the Paramount directors could not contract away their fiduciary obligations. Since the [no-shop provision] was invalid, Viacom never had any vested contract rights in the provision.

Id. at 51.

Similarly, the court held the stock option invalid and, accordingly, "Viacom never had any vested contract rights" in the option. *Id.*

7.3 Pre-Agreement Market Canvas; Post-Agreement Market-Test Provisions and Fiduciary Outs. Although the *Revlon* court refers to directors as "auctioneers" who are charged with the duty of obtaining the best price for the stockholders at a sale of the company, subsequent cases have made it clear that directors are not required to perform a traditional auction in order to satisfy their *Revlon* duties. *Barkan v. Amsted Industries*, 567 A.2d 1279, 1286 (Del. 1989)

("*Revlon* does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest.") The procedures applied by the board must be sufficient to supply them with adequate information to make the best determination for shareholders, but "there is no single blueprint that a board must follow to fulfill its duties." *Id.* "A stereotypical approach to the sale and acquisition of corporate control is not to be expected . . . . Rather, a board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence and in good faith." *Id.* "When multiple bidders are competing for control, this concern for fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another." *Id.* at 1286-87 (citing *Revlon*, 506 A.2d at 182-85). "When the board is considering a single offer and has no reliable grounds upon which to judge its adequacy, this concern for fairness demands a canvas of the market to determine if higher bids may be elicited." *Id.* at 1287 (citing *In re Fort Howard Corp. Shareholders Litig.*, 14 Del. J. Corp. L. 699 (Del.Ch. Aug. 8, 1988)). "When, however, the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market." *Id.*

In *Barkan*, the terms of the management buyout were negotiated by a special committee that was not permitted to solicit competing bids. The court stated that it did "not condone in all instances the imposition of the sort of 'no-shop' restriction" that was in effect here, noting that "[w]here a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids." *Id.* at 1288. The court in *Barkan* recognized that a "judicious market survey" may have been desirable; however, it refused to "fashion an iron-clad rule for determining when a market test is not required", even in the face of "numerous factors" pointing to the "directors' good faith belief that the shareholders were getting the best price". *Id.*

> The evidence that will support a finding of good faith in the absence of some sort of market test is by nature circumstantial; therefore, its evaluation by a court must be open-textured. However, the crucial element supporting a finding of good faith is knowledge. It must be clear that the board had sufficient knowledge of relevant markets to form the basis for its belief that it acted in the best interests of the shareholders. The situations in which a completely passive approach to acquiring such knowledge is appropriate are limited. The Chancellor found this to be such a situation, however, and we believe his finding to be within the scope of his discretion.

Id.

In several cases, the Delaware courts have considered whether a post-agreement "market check" was sufficient for the board of directors to fulfill its fiduciary duty. In *In re Fort Howard Corp. Shareholders Litig.*, 14 Del. J. Corp. L. 699, 705 (Del.Ch. Aug. 8, 1988), the company did not conduct an auction. Rather, it "negotiate[d] provisions purportedly intended to permit an effective check of the market before the [transaction] could close." *Id.* The company had the right to and would entertain alterative proposals. That was made clear in a joint press release issued by the company and the acquiring party. The transaction also provided for a bust-up fee of $1.00 per share (or a total of $67.8 million) in a transaction where the cash purchase price was $53 per share. The company received eight inquiries in response to its press release and cooperated with those companies seeking additional information. The court concluded that this approach " was effective to give the board an informed, dependable basis for the view that the [proposed transaction] is the best available transaction from the point of view of the [company] shareholders." *Id.* The court found this approach

> was reasonably calculated to (and did) effectively probe the market for alternative possible transactions. The alternative "market check" that was achieved was not so hobbled by lock-ups, termination fees or topping fees; so constrained in time or so administered (with respect to access to pertinent information or manner of announcing

> "window shopping" rights) as to permit the inference that this alternative was a sham designed from the outset to be ineffective or minimally effective. ...
>
> Moreover, the rationale for adopting this approach -- for permitting the negotiations with the management affiliated buyout group to be completed before turning to the market in any respect -- makes sense (and thus, cannot alone justify an inference of bad faith). ... To start a bidding contest before it was known that an all cash bid for all shares could and would be made, would increase the risk of a possible takeover attempt at less than a "fair" price or for less than all shares. Accordingly, even if the approach adopted could be said to favor the management affiliated group in the sense that it negotiated its deal without the imposition of time constraints and in a setting in which no other bidders were present -- it does not do so in a way that would support the inference that the decision to do so was not made in the good faith pursuit of the interests of the stockholders.

Id. at 720-21.

In *Roberts v. General Instrument Corp.* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,465 (Del.Ch. Aug. 13, 1990), the target, General Instrument Corp., did not conduct an auction prior to entering into a definitive merger agreement. The merger agreement provided that the company would not solicit alternative buyers and that its directors and officers would not participate in discussions with or provide any information to alternative buyers "except to the extent required by the exercise of fiduciary duties." *Id.* at 97,403. In addition, the merger agreement permitted the company to terminate the agreement if the board determined that a third party offer was on terms more favorable to the company's stockholders than those reflected in the merger agreement. *Id.* Upon such termination, the company would be obligated to pay a fee of $33 million. In connection with the execution of the merger agreement, a press release was issued announcing the fact that the acquiring party would receive a $33 million fee if the board were to accept a higher unsolicited offer. The court noted that the board "would seem to have had adequate information to enter into" the merger agreement.

> The board had been considering strategic alternatives for some time; [its investment bankers] had proposed some value enhancing structural transactions; the board had the benefit of [its investment bankers'] view of value under various scenarios. The company had not been shopped but the merger agreement contained a sufficient fiduciary out, a limited (2%) break-up fee and a sufficient extension of the closing date of the tender offer to permit the board to reasonably conclude that if this deal closed it would represent the best available transaction.

Id. at 97,405.

See also, *In re Formica Corp. Shareholders Litig.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,362, 92,393 (finding a 30 business day market test period to be an adequate procedure to effectively probe the market for possible alternative transactions).

Van Gorkom provides some further insight into the impact of a post-agreement market test. No real market test existed under the original merger agreement in *Van Gorkom*. The Trans Union board was permitted to consider, but not solicit, competing offers for a ninety-day period. However, the initial press release made by Trans Union referenced "definitive agreements" and did not mention that it had retained the ability to receive higher offers. Faced with resignation threats from several key officers of Trans Union, Pritzker orally agreed to several modifications. Primarily, the board was able to authorize the employment of Salomon Brothers, its investment banker, to solicit offers for Trans Union during the proposed market-test period. However, the amendments as proposed to the board by Van Gorkom, and the actual amendments delivered the day after the board's meeting were considerably different. The actual amendments placed serious constraints on Trans Union's ability to negotiate a better deal and

withdraw from the Pritzker agreement. The court found "that confirmation of the appropriateness of the Pritzker offer by an unfettered or free market test was virtually meaningless in the face of the terms and time limitations [in the amended merger agreement]." *Id.* at 885.

Observations. Whether an appropriate post-agreement market test would have excused the board's conduct in *Van Gorkom* is an open question. In this regard, a post-agreement market check is but one aspect of the duty of care analysis; it is unlikely that the mere ability of a board to entertain third party offers will cure an otherwise fatally flawed process where the board has failed to exercise due care.

7.4 No-Shop Provisions. These provisions can have the effect of ending the bidding process or inhibiting other bidders and thus restrict the ability of the board to maximize shareholder value. Frequently, these clauses are subject to some type of “fiduciary out” which permits the board to furnish information to other bidders and to negotiate with them under certain circumstances. According to the court in *Revlon*, "lock-ups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duty." 506 A.2d at 186. However, the use of no-shop clauses is more limited than a lockup agreement. "Absent a material advantage to the stockholders from the terms or structure of a bid that is contingent on a no-shop clause, a successful bidder imposing such a condition must be prepared to survive the careful scrutiny which the concession demands." *Mills Acquisition*, 559 A.2d at 1286 (citing *Revlon*, 506 A.2d at 184).

A no-shop provision was struck down in *QVC* even though it was subject to a fiduciary out. 637 A.2d at 51. In *QVC*, the agreement provided that Paramount would not solicit, encourage, discuss, negotiate, or endorse any competing transaction unless there was a third-party bid which was not subject to any material contingencies relating to financing and Paramount’s board determined discussions were necessary in order to comply with its fiduciary duties. *Id.* at 39. The court found the no-shop provision when combined with a stock option and break-up fee made it more difficult for a potential competing bid to succeed. *Id.* at 49.

However, it should be noted that in *Time*, the Delaware Supreme Court did not strike down a similar no-shop provision, although the provision was not the “central issue” before the court. 571 A.2d at 1154-55.

The court upheld a no-shop provision in *Yanow v. Scientific Leasing, Inc.*, 17 Del. J. Corp. L. 659, 679 (1991), reasoning that the provision did not operate as a lock-up provision because it had a "fiduciary out" provision allowing directors to cooperate with any third party who made a firm written offer that was financially superior to the offer received by the original bidder. According to the court, the provision did not create unreasonable obstacles for future bids, because bidders were free to make firm written offers contingent upon the performance of satisfactory due diligence. *Id.* at 679-80. In fact, the unwillingness of a future bidder to bid in compliance with the provision indicated to the court that the bidder was not seriously considering the purchase and confirmed the court's belief that the SLI board did obtain the highest value available to its shareholders. *Id.* at 680.

Observation. It would appear that after a complete auction process where the highest bidder has been selected by virtue of having the highest bid and all other bidders have had an opportunity to match it, an absolute prohibition against shopping or other transactions may be acceptable.

7.5 Break-up, Topping and Other Fees. Today, a provision for the payment of some type of fee is commonplace. These fees can be payable for anything from failure to obtain shareholder approval to failure to recommend a transaction to the shareholders in light of a competing superior offer. It is clear that fees, while permissible, may not be so high as, either alone or taken with the other provisions of the agreement such as lock-ups, options and no-shop clauses, to preclude other bidders. Standing alone, fees are typically in the 1% to 3% range which appear

acceptable to Delaware courts. However, fees which would be acceptable standing alone can be successfully challenged as part of a package which discourages other bidders. For example, the Court of Chancery struck down a stock option and a no-shop provision but found the 1.2% of merger value or $100 million fee in *QVC Network Inc. v. Paramount Communications Inc.*, 635 A.2d 1245 (Del. Ch. 1993), to be “a fair liquidated amount to cover Viacom’s expenses should the Paramount-Viacom merger not be consummated.” *Id.* at 1271. However, the Delaware Supreme Court took a different view stating that the provisions in the merger agreement were “inseparable” and in this context or together with the stock option and no-shop provision were a deterrent to higher bids. *QVC*, 637 A.2d at 50. In other cases, however, limited break up fees have been upheld even where the "company had not been shopped but the merger agreement contained a sufficient fiduciary out, a limited (2%) break-up fee and a sufficient extension of the closing date of the tender offer to permit the board reasonably to conclude that if this deal closed it would represent the best available transaction.” *General Instrument*, 16 Del. J. corp. L. at 1556.

7.6 Options. The Delaware courts have considered options granted by the target to potential acquirors on several occasions. In *QVC*, 637 A.2d at 39, in striking down the option granted to Viacom, the court stated that "[b]ecause the [option] was not 'capped' to limit its maximum dollar value, it had the potential to reach (and in this case did reach) unreasonable levels." In considering options, acquiring parties and targets would be well advised to consider carefully the court's holding in *QVC*

7.7 Problems with Management Participation in the Transaction. As indicated above, management involvement in a transaction involving the sale of control can raise questions as to the directors' duty of loyalty to the extent that management controls the process or is favored by an otherwise disinterested board. In addition, management participation may trigger the requirements of Rule 13e-3 under the Exchange Act which imposes additional filing and disclosure requirements on the acquiring party in connection with certain "going private" transactions.

8. Other Considerations in Protecting the Deal

8.1 Two-Step Transaction. Transactions are often structured to require the acquiring party to make a tender offer for the outstanding shares of stock (including any associated rights issued under a rights plan) of the target, which tender offer is followed by a second-step merger in which the shares of stock of any remaining stockholders of the target are converted into the right to receive the same consideration as paid in the tender offer. Targets often insist on a first-step tender offer because it generally takes less time to consummate a tender offer than it would to go through the proxy process, hold a stockholders' meeting and effect a merger. Also, there is a presumption that the a transaction effected through a tender offer is more likely to be consummated, due to the advantage of timing, than would be the case in a merger. Acquiring parties favor such a structure for the same reasons. There is a presumption, as well, on the part of targets that an acquiring party that is willing to make a tender offer is probably a more serious purchaser than one who does not want to make such an offer. Appraisal rights present a special concern for an acquiring party effecting a two-step transaction. Stockholders who dissent from a merger are entitled to be paid the "fair value" of their shares in the target as of the merger date. This could present a problem for an acquiring party that does not purchase 90% or more of the outstanding stock of the target in its tender offer and, accordingly, cannot effect the second-step merger immediately thereafter pursuant to the statutory "short-form" merger provisions. Specifically, there is a potential delay between the consummation of the tender offer and the merger under those circumstances. To the extent the acquiring party starts implementing plans or changes in the target during the interim period, those changes will also inure to the benefit of the minority stockholders. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996).

8.2 Certain Additional Covenants of Target. The acquiring party will often insist that the target agree not to waive the target's rights under any standstill agreements entered into with

potential third party acquirors or to redeem any rights issued under, or otherwise terminate, any rights plan the target may have.

8.3 Hart-Scott-Rodino. As discussed above, in Section 2.4.2, a Hart-Scott-Rodino filing may be required in certain instances. Once the required filing has been made, the filings parties are then subject to a waiting period, which begins on the date the FTC receives the required notification and ends on the thirtieth day (absent any requests by the FTC for an extension) thereafter. However, in the case of a tender offer, the waiting period expires on the fifteenth day after receipt of the notification by the FTC.

9. Conclusion