April 10, 2003

Delaware Supreme Court
on "Fiduciary Outs" in Merger Agreements

The Delaware Supreme Court has issued its opinion explicating its summary ruling in the NCS/Genesis/Omnicare case (see our memorandum of December 23, 2002). The 3-2 majority opinion, over vigorous dissents, leaves little doubt that Delaware is now an "option" state – that is, a board of a Delaware corporation cannot agree to a merger agreement without a "fiduciary out" permitting it either to terminate the agreement if a superior proposal emerges or to be certain that the stockholders remain free to reject the original merger in that event. Omnicare, Inc. v. NCS Healthcare, Inc., Del. Sup., No. 605,2002 (Apr. 4, 2003). (This Firm represented Genesis in the matter.)

The majority opinion, by Justice Holland, does not dilute the force of the earlier summary order to the effect that a no-outs merger agreement coupled with a majority-stockholder voting lock up is illegal *per se* – regardless of (1) the unconflicted and fully-informed view of the board that such an agreement was in the stockholders' best interests, (2) the support by stockholders having a majority of the voting power and the largest economic interest, and (3) the belief of both of the board and the controlling stockholders that the inducement of a no-outs merger agreement was the best and only way to obtain the highest value for the stockholders

As a doctrinal matter, the majority holds that "deal protection devices" are subject to Unocal enhanced judicial scrutiny (rather than business judgment review) even in a stock-for-stock merger context. The majority holds that the same rationale for such "reasonableness" review of anti-takeover actions applies to "defensive devices intended to protect a merger agreement that will not result in a change in control." More particularly, the majority unabashedly holds that the "latitude" that a board has in either maintaining or using such provisions depends *post hoc* on "the degree of benefit or detriment to the stockholders' interests that is presented by the value or terms of the subsequent competing transaction."

The majority also declared the merger protections "invalid" on the alternative ground that they "prevented" the board from discharging its "continuing" fiduciary responsibilities to the minority stockholders when a superior transaction appeared. The majority holds that the directors of a Delaware corporation lack "authority" to agree to "an absolute 'lock-up'," and strongly emphasized that directors' fiduciary duties continue after a merger agreement is signed and may not be constrained by contract:

> The directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop after a merger agreement is announced. . . . [T]he NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer. By acceding to Genesis' ultimatum for complete protection *in futuro*, the NCS board disabled itself from exercising its own fiduciary obligations at a time when the board's own judgment is most important, i.e. receipt of a subsequent superior offer.
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> Any board has authority to give the proponent of a recommended merger agreement reasonable structural and economic defenses, incentives, and fair compensation if the transaction is not completed. To the extent that defensive measures are economic and reasonable, they may become increased cost to the

proponent of any subsequent transaction. Just as defensive measures cannot be draconian, however, they cannot limit or circumscribe the directors' fiduciary duties.

The dissenting opinions by Chief Justice Veasey and Justice Steele sharply challenge both the wisdoms and analysis of the majority opinion. Beyond disputing whether the majority fairly considered the factual context of the merger-protective provisions in the particular case, the joint dissent (authored by the Chief Justice) emphasized that any "bright-line rule" against lock-ups could chill permissible conduct and fails to recognize that "[s]ituations will arise where business realities demand a lock-up so that wealth-enhancing transactions may go forward." The dissent declared unwise the majority's "new rule" – that "[a] merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up stockholder approval and does not contain a 'fiduciary out' provision, is per se invalid when a later significant topping bid emerges." The dissent expresses the dual hope that the majority opinion will be interpreted narrowly since by "requiring that there must always be a fiduciary out, the universe of potential bidders who could reasonably be expected to benefit stockholders could shrink or disappear," and that "negotiators may be able to navigate around this new hazard."

In a separate dissent, Justice Steele likewise decried the encouragement of "proscriptive rules" and focused especially on the *post hoc* nature of the majority's analysis:

> If attorneys counseling well motivated, careful, and well-advised boards cannot be assured that their client's decision – sound at the time but later less economically beneficial only because of post-decision, unforeseeable events – will be respected by the courts, Delaware law, and the courts that expound it, may well be questioned. . . .
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> . . .The majority's proscriptive rule limits the scope of a board's cost benefit analysis by taking the bargaining chip of foregoing a fiduciary out "off the table" in all circumstances.

The ramifications of the majority opinion's holding, and its form of analysis, are far-reaching. Many doubtless will argue that the majority opinion departs from the long Delaware tradition of respecting the good faith, informed business decisions of disinterested directors and that the result – as the dissents underscore – will be to diminish stockholder value. Most clearly, no merger agreement – regardless of circumstance – can be locked-up, even at the behest of controlling stockholders and seemingly even at the end of a diligent shopping/auction process. Beyond that, the majority's application of "reasonableness" review to merger-protective provisions and its insistence on directors' post-signing fiduciary duties may herald significant uncertainty about what level of deal protection will be accepted – or whether a later higher bid will just always win.

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