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Delaware Chancery Court Finds Majority Stockholder Lock-Up Permissible Under *Omnicare*

In its recent ruling in *Orman v. Cullman* the Delaware Chancery Court held that a lock-up agreement with a majority shareholder, which survived termination of the merger agreement for 18 months, was not impermissibly coercive under *Omnicare*.

The Cullman family controlled General Cigar Holdings, Inc. through the ownership of all of the Company's Class B Common Stock, which is entitled to ten votes per share. The Company's Class A Common Stock was publicly traded. In late 1999, Swedish Match contacted General Cigar to discuss acquiring a significant stake in General Cigar. Early in the discussions, Swedish Match indicated that "they wanted Edgar M. Cullman, Sr. and Edgar M. Cullman, Jr. to maintain management, responsibility and day-to-day control" of the Company. During the negotiations that led to the merger, Swedish Match required that the Cullmans enter into a stockholders' voting agreement whereby the Cullmans would agree not to sell their shares and to vote against any alternative acquisition proposal for a specified period following any termination of the merger agreement between Swedish Match and General Cigar. The purpose of the voting agreement was to protect Swedish Match against the risk that the Cullmans or General Cigar would "shop" Swedish Match's offer to other potential bidders. This protection was particularly important to Swedish Match because the merger agreement did not contain a termination fee or expense reimbursement provision.

On January 19, 2000, the parties entered into a stock purchase agreement and a merger agreement whereby, following the merger, General Cigar would be owned 64% by Swedish Match and 36% by the Cullmans and the Cullmans would remain in control of the day-to-day operations of the Company. The voting agreement between the Cullmans and Swedish Match provided that the Cullmans would not vote their shares for any alternative acquisition proposal for a period of 18 months following any termination of the merger agreement. The voting agreement also provided that the Cullmans were bound only in their capacities as shareholders and that nothing in the voting agreement limited or affected their actions as officers or directors of General Cigar.

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The merger agreement contained the following key provisions:

- It permitted General Cigar's Board to entertain unsolicited acquisition proposals from potential acquirors if the Board concluded that such proposals would be more favorable to the public shareholders than Swedish Match's proposal.

- It permitted the Board to withdraw its recommendation of the merger with Swedish Match if it concluded that its fiduciary duties so required.

- The merger could not occur without the approval of the majority of the Class A shareholders. Accordingly, the merger could not proceed without approval by a "majority of the minority."

At the shareholders meeting held on May 8, 2000, the public shareholders, i.e., the majority of the minority, overwhelmingly approved the merger.

Plaintiff Joseph Orman sued the General Cigar Board for breach of their fiduciary duties in negotiating the merger terms and, in earlier proceedings, the Chancery Court dismissed most of the plaintiff's claims. The only remaining claim in this proceeding was that the General Cigar public shareholders were impermissibly coerced to vote for the merger because of the lock-up provision required by Swedish Match.

The Court rejected plaintiff's argument that the members of the Cullman family on the General Cigar board breached their fiduciary duties by entering into the voting agreement. This argument, the Court said, rests on a "misapplication" of *Paramount Communications, Inc. v. QVC Network, Inc. (637 A.2d 34 (Del. 1994)) and Omnicare, Inc. v. NCS Healthcare, Inc. (818 A.2d 914 (Del. 2003))*. Those two cases, which provide that a contractual provision requiring directors to act in a manner that limits the exercise of their fiduciary duties is invalid and unenforceable, are not relevant here, the Court said, because the Cullmans entered into the voting agreement as shareholders and nothing in the voting agreement prevented the Cullmans from exercising their duties as directors.

The Court went on to analyze the deal protection mechanism under *Unocal* which requires a board to demonstrate that "they have reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and that deal protection provisions were (a) not coercive or preclusive and (b) within a range of reasonable responses to the perceived danger.

The Court found that the first prong of the *Unocal* analysis was easily satisfied in this case because if the board had not approved the inclusion of the deal protection devices, they risked losing the Swedish Match deal and being left with no alternative transaction.

Applying the second prong of the *Unocal* analysis, the Court found that the deal protection devices were not coercive. Unlike the situation in *Omnicare*, the deal protection mechanisms at issue in this case were not tantamount to a *"fait accompli."* The public shareholders were free to reject the proposed deal, even though their vote may have been influenced by the existence of the deal protection measures. Here, the Court said, "because General Cigar's public shareholders retained

the power to reject the proposed transaction with Swedish Match, the fiduciary out negotiated by General Cigar's board was a meaningful and effective one—it gave the General Cigar board power to recommend that the shareholders veto the Swedish Match deal."

In *Omnicare*, the board of directors of NCS Healthcare, Inc. approved a merger with Genesis Health Ventures, Inc. The deal was protected with a 3-part defense that included (1) the inclusion of a Section 251(c) "force the vote" provision in the merger agreement; (2) the absence of any effective fiduciary out cause; and (3) a voting agreement between two NCS shareholders and Genesis which ensured that a majority of shareholders voted in favor of the transaction. After the merger was approved by the board and another suitor, Omnicare, Inc., made a superior proposal, the NCS board changed its recommendation and recommended that the NCS shareholders vote against the Genesis merger. This change of heart, however, had no practical effect because the three deal protection devices, working together, guaranteed that the Genesis transaction would obtain NCS stockholders' approval.

Unlike *Omnicare*, nothing in the merger or stockholder agreements in this case made it "mathematically certain" that the transaction would be approved. The General Cigar board retained a fiduciary out, and a majority of the non-affiliated public shareholders could have rejected the deal on its merits.

The Court acknowledged that the Cullman vote against any future, hypothetical deal was "locked-up" for 18 months. "It was this deal or nothing, at least for that period of time." Since no other suitor was waiting in the wings, the Court reasoned, assuming a shareholder believed that General Cigar's long term intrinsic value was greater than the merger price, the 18 month delay was not an unreasonable "cost," given the absence of other deal protection devices in this transaction and the buyer's concern about transaction costs and market uncertainties. To find that the voting minority was coerced in this case would have required the Court to hold that "being in a voting minority automatically means that the shareholder is coerced," a proposition for which the Court could find no support in either *Omnicare* or any other decisional authority.

The *Orman* decision is a narrow reading of *Omnicare* and suggests that the Delaware courts will uphold strong lock-ups as long as the merger remains subject to a meaningful stockholder vote, *i.e.*, one in which the minority stockholders retain the ability to vote against the transaction. *Orman v. Cullman*, Del. Ch., CA No. 18039, October 20, 2004.

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This memorandum constitutes only a general description of the *Orman* opinion. It is not intended to provide legal advice and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to any of the following members of our Mergers and Acquisitions Group:

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