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Delaware Supreme Court Holds "Absolute Lock-ups" Invalid

In a controversial opinion that had been eagerly anticipated by the M&A community, the Delaware Supreme Court on April 4, 2003 held that voting agreements with a majority stockholder, together with a merger agreement containing a provision requiring that it be presented to the stockholders for a vote regardless of whether the target's board continued to recommend the merger, are preclusive and coercive in the absence of an effective fiduciary out and, therefore, the voting agreements and the merger agreement are invalid and unenforceable.

In late 1999, NCS Healthcare, Inc. began to face financial difficulties and the market value of its stock began to decline. As a result, it began to explore strategic alternatives. In the summer of 2001, Omnicare, Inc., a competitor of NCS, proposed to acquire NCS in a bankruptcy sale under §363 of the Bankruptcy Code. Under that proposal, Omnicare would have paid substantially less than the face value of NCS's outstanding debt and would have provided no recovery for its stockholders. NCS rejected Omnicare's offer. By early 2002, NCS's financial condition was improving and the NCS directors began to believe that it might be possible for NCS to enter into a transaction that would provide some recovery for NCS's stockholders. In early 2002, Genesis, another competitor, executed a confidentiality letter and began due diligence. In June, 2002 Genesis, fearing that it might be used by NCS as a "stalking horse," demanded that NCS agree to an exclusivity agreement with it. After Genesis increased its offer, NCS granted Genesis exclusivity. At that point, the Genesis proposal included full repayment of NCS's debt and a small payment to NCS stockholders in the form of Genesis stock.

In late July 2002, Omnicare learned that NCS was negotiating with Genesis and sent NCS a proposal for a transaction in which all the debt would be paid off and the NCS stockholders would get a greater return than that offered by Genesis but which was subject to due diligence and other conditions. NCS asked Omnicare to drop its due diligence condition but Omnicare refused. Faced with a risk that Genesis would walk away, NCS refused to negotiate with Omnicare but used Omnicare's proposal to negotiate for better terms with Genesis. Genesis then improved the terms of its offer but, in return for these concessions, demanded that the offer be approved by midnight the next day or else Genesis would withdraw its offer.

On July 28, the NCS Board met and approved the Genesis transaction. The parties executed a merger agreement providing for NCS stockholders to receive Genesis stock and for all NCS debt to be paid off. The merger agreement included a "force-the-vote" provision under §251(c) of the Delaware

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corporation law requiring NCS to submit the merger to NCS stockholders regardless of whether the NCS Board continued to recommend the merger and, at the insistence of Genesis, the NCS Board agreed to omit any effective fiduciary out clause from the merger agreement. In addition, as part of the overall transaction, two stockholders of NCS who held a majority of the voting power of NCS (through ownership of a class of high-vote stock) executed a voting agreement whereby they unconditionally agreed to vote in favor of the merger. Thus, the combined terms of the voting agreements and merger agreement guaranteed, *ab initio*, that the transaction proposed by Genesis would obtain NCS stockholders' approval.

Omnicare immediately commenced a lawsuit attempting to enjoin the NCS/Genesis merger and, one week later, began a cash tender offer for NCS's shares at $3.50 per share, an amount equal to more than twice the then current market value of the shares to be received in the Genesis merger. The transaction offered by Omnicare also treated NCS's other stakeholders on equal terms with the Genesis agreement. Several months later, but before the stockholder vote on the NCS/Genesis merger was scheduled, Omnicare irrevocably committed itself to a transaction with NCS. As a result, the NCS Board withdrew its recommendation of the Genesis merger and NCS's financial advisor withdrew its fairness opinion. The NCS Board recommended that the stockholders reject the Genesis transaction because the competing proposal from Omnicare was a "superior proposal."

The Chancery Court, in a ruling November 22, 2002, held that the decision of the NCS Board to approve the merger with Genesis was not subject to *Revlon* because the transaction did not result in a change of control and because NCS had not started "an active bidding process" to sell itself and reviewed it under the business judgment rule standard, concluding that the NCS Board had not breached its duty of care in approving the Genesis merger. The Chancery Court also held that the voting agreements, combined with the "force-the-vote" provision and the absence of effective fiduciary out, constituted defensive measures within the meaning of *Unocal* and, applying the *Unocal* standard of enhanced scrutiny, the Court held that those defensive measures were reasonable. On December 10, the Supreme Court reversed in a 3-2 summary order stating that the deal protection provisions were unreasonable because, in the absence of a fiduciary out clause, they "precluded the directors from exercising their continuing fiduciary obligation to negotiate a sale of the company in the interest of the shareholders".

The April 4, 2003 opinion, written by Justice Randy Holland, provides the rationale underlying the December 10 order. The Supreme Court said it would not revisit the business judgment rule/duty of care analysis because it was not "outcome determinative" for purposes of the appeal. Analyzing the deal protection provisions under *Unocal's* two stage analysis, the Court said that the NCS directors first had to demonstrate that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed. To satisfy that burden, the NCS directors were required to show they acted in good faith after conducting a reasonable investigation. Here, the threat identified by the NCS Board was the possibility of losing the Genesis offer and being left with no comparable alternative transaction.

The second stage of the *Unocal* test requires the NCS directors to demonstrate that their defensive response was "reasonable in relation to the threat posed." This inquiry itself involves a twostep analysis. The NCS directors must first establish that the deal protection devices adopted in response to the threat were not "coercive" or "preclusive" and then demonstrate that their response was within a "range of reasonable responses" to the threat perceived.

In this case, the Court said "the deal protection devices of the NCS board were *both* preclusive and coercive" and thus under *Unocal* "they are draconian and impermissible." Here, the Court stated, "any stockholder vote would have been robbed of its effectiveness by the impermissible coercion that predetermined the outcome of the merger without regard to the merits of the Genesis transaction at the time the vote was scheduled to be taken." Likewise, the deal protection devices were preclusive because they "preclude the consideration of any superior transaction." Therefore, the NCS directors' defensive devices were not within a reasonable range of responses to the perceived threat of losing the Genesis offer and accordingly, the Court held that they were unenforceable.

The Court went on to say that the deal protection provisions were unenforceable "not only because they are preclusive and coercive but, alternatively, ... they are invalid as they operate in this case" because "the merger agreement completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction." Here, the Court said, "the NCS Board could not abdicate its fiduciary duties to the minority by leaving it to the stockholders alone to approve or disapprove of the merger agreement because two stockholders had already combined to establish a majority of the voting power that made the outcome of the stockholder vote a foregone conclusion." Thus the Court held that the NCS Board did not have authority to accede to the Genesis demand for an "absolute lock- up" and it was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer. Accordingly, the voting agreements and the §251(c) provision, although they are two otherwise valid actions, are inconsistent with the NCS directors' fiduciary duties when combined to operate in concert in the absence of an effective fiduciary out.

In a dissent, Chief Justice Norman Veasey and Justice Myron Steele opined that the NCS Board's actions should have been evaluated based on the circumstances at the time the Genesis merger agreement was entered into, before Omnicare's hostile bid emerged. The lock ups were reached at the conclusion of a "lengthy search and intense negotiation process in the context of insolvency" at a time when Genesis was "the only game in town" and were the result of a disinterested and informed board decision reached in good faith and therefore, in the dissenting Justices' view, they should have been upheld. In conclusion, the dissenting Justices express the hope that "the Majority rule...will be interpreted narrowly and will be seen as *sui generis*" and add that "[by] deterring bidders from engaging in negotiations like those present here and 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. Nevertheless, if the holding is confined to these unique facts, negotiators may be able to navigate around this new hazard."

The *Omnicare* decision, while it mandates the use of fiduciary out clause where a controlling shareholder has agreed to support a merger, does not seem to prohibit entering into a non-change-of-control stock-for-stock merger without an effective fiduciary out as long as the merger remains subject to a *meaningful* stockholder vote, *i.e.*, one where the result is not a foregone conclusion. *Omnicare, Inc. v. NCS Healthcare, Inc. et al.* , Del. Sup. Ct., No. 605, 2002, April 4, 2003.

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This memorandum constitutes only a general description of the *Omnicare* 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 New York-based members of our Mergers and Acquisitions Group:

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