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Advisory

Spring 2004

MERGERS AND ACQUISITIONS

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New Limitation on the Use of Lock-up Agreements

by Paula Valencia-Galbraith and Christopher Jones

Introduction

A recent split decision (3-2) of the Delaware Supreme Court has changed the rules regarding the use of shareholder lock-up agreements. Traditionally, lock-up agreements have been used by acquirers seeking assurance that certain target company shareholders (usually management or controlling shareholders) will vote in favor of a proposed transaction. The ability to obtain this assurance, and the concomitant bargaining chip it represented for a target company and its shareholders, has been substantially diminished by the Delaware Court's recent decision. The Court held that, where shareholders of a target company have entered into binding agreements to vote in favor of a proposed merger in sufficient numbers to ensure shareholder approval of the transaction, the target company must retain the ability to terminate the merger agreement in the event that a superior offer is presented by a third party prior to closing. This decision represents an expansion of the circumstances in which a target company must retain a so-called "fiduciary out." Previously, regardless of whether shareholder lock-ups were actually used, this kind of obligation did not arise in the context of a negotiated strategic merger with a widely held acquirer.

While the opportunity to lock up enough shareholder votes to approve a merger may not arise very often outside the sale of small privately held companies, this decision does apply to every corporation incorporated under Delaware law. Consequently, this new obligation should be recognized by officers and directors of companies entering into merger negotiations and fully understood by their legal and financial advisors.

Facts Underlying the Decision

In July 2002, Genesis Health Ventures, Inc. ("Genesis") entered into a merger agreement with NCS Healthcare, Inc. (NCS). The agreement represented the culmination of a two-year effort by the NCS Board of Directors to find a means of preserving shareholder and creditor interests in their financially distressed company. The process leading up to the execution of the merger agreement between NCS and Genesis was far from the sort of hasty transaction that typically attracts the Court's attention. In this case, the NCS Board of Directors worked diligently over a two-year period with two successive investment banks in an effort to find a

Top Ten Hart-Scott-Rodino (HSR) Myths

by *Fernando LaGuardia*

Myth 1. “This deal is small potatoes, it won’t trigger HSR.” Fact: Any deal valued at \$50 million or more should be evaluated for HSR. And there are special rules under HSR for determining “value.” It’s not always just the purchase price, or what’s involved in the immediate deal. Past deals may need to be aggregated with the current deal for valuation.

Myth 2. “This isn’t a merger, it’s a license deal—HSR doesn’t apply.” Fact: If it’s an exclusive license (which is an asset for HSR purposes) and is worth more than \$50 million, it should be evaluated for HSR.

Myth 3. “We’re not merging, we’re just acquiring an interest—no need to worry about HSR.” Fact: If the transaction involves the acquisition of \$50 million in stock or assets, HSR may apply.

Myth 4. “Our client holds convertible shares, warrants and options; they were exempt from HSR when our client got them, so we don’t need to worry about HSR when they are converted.” Fact: The conversion of convertible shares, warrants or options can trigger HSR.

Myth 5. “We’re just forming an LLC/setting up a JV corporation—HSR doesn’t apply to that.” Fact: The formation of an LLC or a corporation can trigger HSR.

Myth 6: “Our client wants to acquire interests in an LLC or partnership—there’s no HSR.” Fact: The acquisition of 100% of the interests in an LLC or partnership can trigger HSR. Moreover, acquisitions of less than 100% of the interests in an LLC may be reportable if contributions of assets (including exclusive licenses or IP) or voting securities are made to the LLC at the same time.

Myth 7: “Our client just acquired some stock/assets of another entity and filed HSR; now it wants to acquire more—we don’t have to file another HSR.” Fact: Additional acquisitions of stock/assets can trigger HSR whether or not the earlier acquisition required a filing.

Myth 8: “The transaction is between two foreign companies, that can’t possibly trigger HSR.” Fact: Transactions between foreign companies can trigger HSR if sufficient US assets or sales are involved.

Myth 9: “We’re just investing in another company; HSR doesn’t apply.” Fact: A holding totaling more than 10% of the outstanding voting stock can trigger HSR.

Myth 10: “We can structure a reportable transaction so as to avoid HSR.” Fact: This is illegal and will result in substantial penalties.

transaction that might allow creditors and equity holders to recover some of the value of their investment in NCS. During the course of their effort, over fifty possible transaction partners were contacted. Of the few proposals received by NCS, the Genesis proposal was the only one that promised some degree of recovery for NCS’ equity holders. NCS had held discussions with OmniCare, Inc. (“OmniCare”), the party that subsequently attacked the proposed merger with Genesis; however, in each instance, OmniCare was only interested in buying the assets of NCS in a bankruptcy sale that would leave little or nothing for NCS’ common equity holders.

The Court did not challenge the decision of the NCS Board in electing to pursue a transaction with Genesis. The Court’s objection to the merger lay in the fact that the merger agreement did not permit NCS to terminate the agreement in the event that a superior offer was presented by a third party prior to closing. This limitation, coupled with the prior agreement of shareholders of NCS controlling more than fifty percent of the outstanding votes to vote in favor of the transaction, meant that from the signing of the merger agreement the proposed merger was, as the Court wrote, a *fait accompli*. No matter what other offers were presented, shareholder approval was ensured and NCS had no right to terminate the merger agreement.

As a condition to proceeding with the transaction, Genesis demanded an irrevocable commitment to consummation of the proposed merger by NCS and the NCS shareholders controlling sufficient votes to approve the merger. This requirement arose from its past experience of having lost a strategic merger partner to another bidder, which by coincidence was OmniCare, after having spent considerable time and effort to structure a transaction. The proposed merger with Genesis was neither the result of the NCS Board’s irrevocable decision to sell or break-up the company, nor would it result in a change of control of NCS. It was in fact a strategic merger falling outside the defined scope of transaction for which Delaware law had articulated the need to remain open to competing offers subsequent to signing a merger agreement. Consequently, the request by Genesis to irrevocably lock-up the deal at the signing of the merger agreement was not at odds with Delaware law.

The decision of the NCS Board to lock-up the merger arose after careful consideration of the risks and benefits associated with that decision. Shortly before the anticipated signing of the merger agreement with Genesis, OmniCare became aware of the proposed transaction and presented an alternative proposal to NCS that was financially superior. As a result of this new offer, the NCS Board was able to negotiate an increase in the amount of the Genesis offer. Although the final amount of the Genesis offer was less than the amount offered by OmniCare, OmniCare’s offer was subject to the satisfaction of several conditions, including satisfactory completion of its due diligence review of NCS. Due to the conditional nature of the offer, the

NCS Board concluded that the inherent uncertainty as to an ultimate transaction price, or even whether a transaction would be consummated, made Omnicare's offer less appealing than the unconditional offer presented by Genesis. Genesis was unwilling to continue proceeding toward a transaction, and threatened to terminate discussions, unless it received an irrevocable commitment from NCS and its majority shareholders. Faced with the prospect of losing the only acceptable firm offer that had materialized after two years of searching, NCS chose to proceed, irrevocably, toward consummating a merger with Genesis.

Conclusions

The Court's decision imposes new duties on the boards of Delaware corporations and qualifies the ability of Delaware corporations to enter into negotiated strategic mergers. Now, even in a negotiated strategic merger not resulting in a change of control, if a controlling shareholder vote is committed in advance to supporting the transaction, the merger must remain terminable by the target company if presented with a superior proposal. In the proposed merger between Genesis and NCS, this termination right was strategically relinquished by NCS in the course of committing to a transaction that it regarded as the best available option after a long and exhaustive consideration of its alternatives. Henceforth, this bargaining chip will no longer be available to target companies.

Another issue that remains to be determined and should be addressed is what constitutes a controlling shareholder vote. In the case of NCS, approval of the transaction required a vote of the majority of the outstanding common shares. In light of the fact that controlling shareholders represented over eighty percent of the votes attached to outstanding common shares, the Court referred to

the threshold as being that number of shares required to approve the transaction. However, it is generally recognized that in a widely held corporation, a shareholder controlling less than the required number of votes to give effect to a transaction might still, by virtue of having a large block of shares under control, carry sufficient weight to effectively control the outcome of a proposed transaction. Consequently, it remains possible for a future court to determine that the scope of what constitutes control applies, in such circumstances, to a block of shares representing something less than the number of shares required to approve the proposed transaction.

It must be recognized that two justices strongly dissented from the decision of the court: "[o]ne hopes that the Majority rule announced here—though clearly erroneous in our view—will be interpreted narrowly and will be seen as *sui generis*. 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."¹ It remains possible that this decision will, in the future, be applied in the narrowest possible manner. However, until further case law modifies the decision, the new rule regarding the use of "fiduciary outs" with lock-up agreements must be respected.

Imprecise Drafting Results In Unanticipated Loss Of Class Voting Rights

by *Kostantinos Sofronas*
and *Christopher Jones*¹

The decision rendered in the case of *Benchmark Capital Partners IV, L.P. v. Juniper Financial Corp. et al.*² dramatically reinforces the need for clear, accurate and complete language in contracts and other documents. In its decision, the Court of Chancery of Delaware (the "Court") held that the class and series approval rights of a corporation's preferred stockholders with respect to changes in the rights, preferences and privileges of their preferred stock could not be inferred to create similar approval rights with respect to a merger that would eliminate such approval rights with respect to the surviving entity. This decision enabled the corporation to circumvent shareholder class and series approval requirements otherwise arising in connection with a proposed Series D Preferred Stock financing by effecting the financing immediately subsequent to a merger that (i) was not expressly subject to such class and series approval rights, and (ii) eliminated those rights with respect to future actions of the surviving entity. This case strongly reasserts the Court's reluctance to infer in documents an intention that is not expressly stated. It is also a harsh reminder that even slight ambiguities in documents can result in unanticipated and severe consequences.

The plaintiff, Benchmark Capital Partners IV, L.P. ("Benchmark"), was an investor holding shares of Series A and B Preferred Stock of the defendant, Juniper Financial Corp. (the "Corporation"). The Corporation was having difficulty raising additional financing that it required. Canadian Imperial Bank of Commerce (CIBC), an existing holder of Series C Preferred

¹ (*New Limitation*) *OmniCare, Inc. v. NCS Healthcare, Inc.*, No.605, 2002, Holland, J. (Del. April 4, 2003)

¹ (*Imprecise Drafting*) Written with the assistance of Kenneth Sullivan.

² 2002 WL 1732423 (Del.Ch.). The individuals defendants not named above are: Richard Vague and James Stewart, founders and officers of Juniper Financial Corp.; and John Tolleson, who is a member of the special committee appointed by the board of directors of Juniper to review the Series D financing.

Stock, agreed to purchase \$50 million of newly created Series D Preferred Stock. The consequences to Benchmark and other holders of Series A and B Preferred Stock would be both the further subordination of their ownership interests behind the newly invested \$50 million and the reduction of their aggregate ownership interest in the Corporation from 29% to 7%.

In light of the proposed subordination and diminution of its interest in the Corporation, Benchmark objected to the proposed financing. In objecting, Benchmark had several protective mechanisms at its disposal with which it believed it could block the Series D financing. More specifically, the Corporation's Certificate of Incorporation included broad protective provisions, including approval rights of Series A and B Preferred Stockholders as to (i) to the issuance of equity senior to or on a parity with the Series A and B Preferred Stock, (ii) any amendment to the Certificate of Incorporation that "materially adversely" alters preferred stockholder rights, preferences and privileges, (iii) any sale of substantially all of the Corporation's assets, and (iv) any consolidation or merger, *other than a merger with a wholly-owned subsidiary*. As discussed below, unfortunately for the Series A and B Preferred Stockholders, inclusion of the seemingly innocuous "*wholly-owned subsidiary*" exception to the merger approval requirement would prove very costly.

Anticipating that the Series A and B Preferred Stockholders would attempt to rely on the approval mechanisms in the Corporation's Certificate of Incorporation to thwart the proposed Series D financing, the Corporation pursued an alternative structure for the transaction. Instead of simply creating and issuing a new series of Preferred Stock, the Corporation would merge with a wholly-owned subsidiary created for the purpose, with the Corporation being the surviving entity. As described above, the Corporation's Certificate of Incorporation provided for mergers with wholly-owned subsidiaries

to be effected without obtaining class or series approval from the Series A and B Preferred Stockholders. An integral part of the plan was that the Certificate of Incorporation of the entity surviving the merger would not include the type of class and series approval requirements by which the Series A and B Preferred Stockholders could currently prevent the Corporation's proposed Series D financing. Immediately following the merger, the Corporation (as the entity surviving the merger) would effect the proposed Series D financing without the need for class or series approval by the Series A and B Preferred Stockholders. The resulting subordination and dilution of the Series A and B Preferred Stockholders would be similar to that which would have resulted from effecting the proposed Series D financing without the intervening merger transaction.

Benchmark objected to the Corporation's effort to achieve indirectly what it was not able to achieve directly and filed a motion for a preliminary injunction to stop the proposed transaction. In its motion, Benchmark took the position that, regardless of the "*wholly-owned subsidiary*" exception to the requirement for class and series approval of a merger, the Corporation could not undertake a merger with a wholly-owned subsidiary without such approvals where the transaction's sole purpose was to eliminate those approval rights in the surviving entity in order to enable the Corporation to complete a financing that would otherwise be subject to such approval requirements. Benchmark argued that the approval rights of the Series A and B Preferred Stockholder were applicable as a consequence of the proposed material adverse changes to the rights, privileges and preferences of the Series A and B Preferred Stock, regardless of whether a merger with a wholly-owned subsidiary is otherwise exempt from class or series voting rights.

The Corporation countered by arguing that (i) the class and series approval rights asserted by Benchmark were

intentionally excluded from the approval requirements for a merger of the Corporation with a wholly-owned subsidiary, and (ii) that amendments of the rights, privileges and preferences of the Preferred Stock incidental to a merger with wholly-owned subsidiary could not be inferred to create any such class or series approval requirements.

The Court denied Benchmark's motion for a preliminary injunction. The Court based its decision on the fact that all parties to the various rounds of financing were "sophisticated investors" and that it must presume that the inclusion of "*wholly-owned subsidiary*" merger exception in the Certificate of Incorporation was by intent. By accepting this language as drafted, the Court concluded that the Series A and B Preferred Stockholders did not have class or series approval rights over the proposed merger, the resulting alteration of the rights and preferences of the Series A and B Preferred Stockholders or the subsequent Series D Senior Preferred Stock offering.

In this instance, the Corporation was able to achieve through an alternative structure the financing that it could not have accomplished directly. While this decision is not without precedent, it does provide a concise articulation of the Court's position on this issue: On the one hand, this decision warns that stockholder rights must be carefully crafted to ensure that they are preserved in all relevant circumstances. On the other hand, it demonstrates that careful reading of applicable documents and creative thinking can achieve an objective that might at first seem unobtainable.

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