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Delaware Decisions: Data Points, Not Doctrine

There is a risk of overreaction if snippets from Delaware court decisions are turned into universal principles, particularly when taken out of the all-important factual context of the relevant cases.

Delaware courts often take an expansive approach to decision-making, offering detailed commentary on the facts and the underlying law in many key M&A cases. While these lengthy opinions can offer market participants useful insights into best practices for future deals, it is equally important that dealmakers not overreact to observations that should, and no doubt are intended to, be read within the context of the specific circumstances before the court. In seeking guidance from court decisions, readers should be mindful that, more often than not, it is only the cases with the worst, or at least most complicated, facts that make it to a final court decision, exacerbating the risk reflected in the old legal adage that "hard cases make bad law". A few examples may be useful.

Stapled Financing In his 2005 *Toys "R" Us, Inc.* decision, then VC Strine was critical of the decision to allow one of the target board's financial advisers to offer financing to the winning bidder after the merger agreement was signed. Some commentators interpreted the court's comments as blanket discouragement of the practice of "stapled financing" being offered to bidders by a target adviser. However, VC Strine himself later publicly commented that such a reading "misconstrued" his opinion and that there were situations where it would be appropriate for a seller, through its banker, to offer financing to potential bidders (for example, in order to stimulate interest among buyers, to reduce the risk of leaks or to set a valuation floor for an auction). His criticism in *Toys* was directed at the risk of appearance of conflict generated by the request of the adviser (and agreement by the board) to offer financing once the deal was already signed, meaning the financing role served to only generate fees for the lending bank as opposed to any useful function for the target. A similar nuanced reading is required of VC Laster's recent commentary on stapled financing that played a significant role in the fairly scathing *Del Monte* decision. Rather than suggesting that stapled financing is *per se* problematic, VC Laster implied that the court will seek evidence that allowing a sell-side adviser to offer a buyer financing had "some justification reasonably relating to advancing stockholder interests". Instead of the reflexive avoidance of stapled financing that occurred in the aftermath of each of these two decisions, a more refined reaction requires principals and their advisers to critically assess whether such financing could in fact advance the target's interests and, if such financing is in fact offered, to ensure that it is done with the full knowledge of the board with appropriate protections in place to address any resulting potential conflicts (e.g., by early engagement of a second, non-financing adviser).

Banker Conflicts In the aftermath of Chancellor Strine's recent decision in *El Paso*, there has been widespread focus on potential conflicts that a target financial adviser may have as a result of a broad variety of factors, including stock ownership and/or business relationships with a potential buyer. While one could certainly envision extreme scenarios where the conflicts were so great as to be disabling under any circumstances, a more apposite approach in most situations would be to ensure that any potential conflicts are fully aired with the target's board at the outset of an engagement (and properly disclosed to shareholders in any proxy or tender offer document) and that, where appropriate, effective controls are established to mitigate any resulting risks. In fact, VC Parson's decision in *Micromet*, ironically published the same day as *El Paso*, shows the refined approach of the Delaware courts to this issue — as compared to the concerns expressed in *El Paso* resulting from the target adviser's 19% interest in the buyer (coupled with other concerns such as advisory fee structures), that same adviser's $336 million ownership of buyer stock in *Micromet* (mostly on behalf of clients) was dismissed as wholly irrelevant within the particular circumstances of that case. The Delaware courts are undoubtedly cognizant and respectful of the fact that the most effective advisory services are often rendered by bankers with relationships that run broadly and deeply in the relevant industry. In general, the courts are not seeking to dictate the choice of adviser, but rather are promoting transparency and supervision (e.g., additional advisers, appropriate fee structures, etc.) as a counterweight to apparent or actual conflicts.

CEO Leading Sale Negotiations In *El Paso*, Chancellor Strine was clearly troubled by the target board deferring to the CEO as the lead negotiator on behalf of the target. However, it is important to note that Strine was not changing his view expressed in *Toys* that there is no "status crime of being a CEO". Rather, he was disturbed

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by what he viewed as the CEO's "velvet glove" negotiating strategy possibly being influenced by an improper motive — namely, his desire to lead a management buyout of one of the target's divisions following completion of the sale. Absent such a conflict, the courts have consistently recognized that a CEO is often the very best person to lead negotiations on behalf of the target given his or her knowledge of the business and, quite often, significant financial stake in an optimal price outcome for the target shares. Again, the courts are not universally mandating day-to-day management of a sale process by the independent directors to the exclusion of executives; instead, the courts are asking the board and executives to openly and honestly assess whether there may be conflicts or improper motives and ensuring that, where needed, appropriate safeguards (e.g., a special committee, a board member assigned to complement the CEO, etc.) are implemented.

Significant Shareholder Seeking Liquidity Absent differential consideration or a rollover of its stake, the general view was that a significant target shareholder (and its affiliated directors) did not face a conflict as a result of the size of its stake, not least because it, more than any shareholder, had an incentive to maximize the outcome for the benefit of target shareholders. However, in two recent decisions, *infoGroup* and *Answers*, VC Noble, building on the 2000 *McMullin* decision that suggested that obtaining liquidity is a benefit that may result in directors breaching their fiduciary duties, explicitly raised the prospect of a disabling conflict for affiliated directors by virtue of the deemed receipt of a "material benefit" different than other shareholders where a significant shareholder is seen to press for a sale because of a desire or need for liquidity. However, it is important to note that the *infoGroup* case included allegations of broad-ranging egregious behavior on the part of the director who owned 37% of the target (well beyond simply pushing for a sale) and the *Answers* decision came at a preliminary stage of the litigation on a motion to dismiss. Again, we do not believe that the court is seeking the automatic exclusion of a significant shareholder and related directors from sale discussions merely because of the size of its stake or its willingness or desire to obtain liquidity at a premium (presumably the investment rationale of all shareholders). Rather, the court is asking boards to be mindful of undue pressure that may be applied to effect a sale at a time or at a value that is not in the best interests of all shareholders if a particular large shareholder is motivated by, and skews or manipulates a sale process in the interest of, a pressing liquidity concern (such as the director's alleged personal liquidity needs in *infoGroup*) and, if necessary, to address those conflicts with appropriate independence and protections.

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Decisions emanating from the Delaware Chancery courts, as the preeminent M&A adjudication forum, offer important guidance for market participants across the country. However, there is a risk of overreaction if snippets from those decisions are turned into universal principles, particularly when taken out of the all-important factual context of the relevant cases. Most of the time, the Delaware courts are not asking dealmakers to suddenly jettison well-established and well-grounded practices — rather they are using the medium of court opinions to identify for dealmakers certain issues to which they should be attuned, most often via transparency and disclosure, in the hopes of avoiding negative litigation outcomes in the future.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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