

Information Advisory

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Delaware Supreme Court Rules That Merger Lock Up Provisions May Violate Directors' Duty of Care

The Delaware Supreme Court recently issued a warning regarding lock up arrangements in merger and sale transactions. While the court has not yet issued a full opinion, its two-page order was based on a finding that directors of Delaware corporations in seeking a transaction that would yield the highest value available for stockholders may not agree to deal protection measures that preclude them from exercising their continuing fiduciary obligation to negotiate a sale in the interests of shareholders.

On December 10, 2002, the Delaware Supreme Court enjoined consummation of a merger, ruling that the target company's directors had breached their fiduciary duty of care by (1) agreeing to present the merger agreement to stockholders even though the board of directors had withdrawn its recommendation and (2) approving stockholder voting agreements that ensured that a majority of shares would be voted in favor of the merger. Both actions are permitted under the Delaware code. But in this combination, the court held, these provisions precluded the directors from exercising their continuing fiduciary obligation.

The transaction involved NCS Healthcare, Inc. ("NCS"), an insolvent Delaware corporation that was the object of two competing acquisition bids. An independent committee of NCS directors initially entered into extended negotiations with Omnicare, Inc. ("Omnicare") but these negotiations bogged down over Omnicare's insistence on a bankruptcy sale rather than a merger. Subsequently, NCS entered into discussions with Genesis Health Ventures, Inc. ("Genesis") a direct competitor of Omnicare. Fresh off a bitter, and losing, bidding war with Omnicare for another company, Genesis required NCS to execute exclusivity agreements and lock ups related to any potential transaction.

Negotiations with Genesis proceeded quickly and ultimately resulted in a deal that would have not only paid off NCS's creditors but also resulted in the issuance of Genesis stock to NCS stockholders. At this point, Omnicare reentered the picture with a merger offer conditioned upon a due diligence investigation. Omnicare's offer provided superior terms to NCS stockholders but less attractive terms with regard to NCS's creditors. Given its past experience with Omnicare and the uncertain outcome of a due diligence investigation, the NCS board was reluctant to risk losing Genesis based solely on a highly conditional offer by Omnicare. However, NCS did leverage the Omnicare offer to seek improved terms from Genesis. Genesis responded with an enhanced, take-it-or-leave-it offer with a 24-hour deadline.

Under the terms of the final Genesis agreements and as permitted by Delaware law, the NCS board was required to submit the merger agreement to its stockholders even if the board subsequently withdrew its recommendation. Additionally, in accordance with DGCL §203, the board authorized two NCS directors/shareholders, who together held majority voting control, to enter into voting agreements obligating them to vote in favor of the merger as well as grant an irrevocable proxy to Genesis to vote in favor of the merger. The board was advised by counsel that these terms would assure shareholder approval and would prevent NCS from engaging in alternative transactions.

The board proceeded with the Genesis transaction. Omnicare then responded with a tender offer on better terms than the Genesis merger transaction. Ultimately the NCS board, acting under its limited fiduciary out in the Genesis agreement, obtained a commitment from Omnicare to a transaction on substantially better terms than the Genesis transaction. The board then withdrew its recommendation in favor of the Genesis transaction; the financial advisor withdrew its fairness opinion. Nevertheless the two-part deal protection of the Genesis agreements remained in place: (1) the Genesis merger would be presented to stockholders for a vote and (2) Genesis had a majority vote, complete with irrevocable proxies, locked up.

Both Omnicare and NCS shareholders then filed suit seeking to enjoin the merger with Genesis. The Chancery Court ruled that the board had acted in a reasonable manner given the circumstances. Considering NCS's dire financial condition, the obligation owed to NCS's creditors and the board's previous experience with Omnicare, the court ruled that the NCS board acted appropriately in approving the deal protection terms of the Genesis merger.

However, in a very brief disposition, the Delaware Supreme Court noted that, by approving the voting agreements and by agreeing to present the merger to the stockholders regardless of intervening offers or events, the NCS board irrevocably locked up the merger with Genesis. In the absence of a fiduciary out clause, the court said, these provisions blocked the directors from exercising their continuing fiduciary duty to negotiate a sale of the company in the interest of the stockholders.

The full implications of the ruling are not yet clear. The Genesis merger agreement did contain a limited fiduciary out clause. The voting agreements apparently did not. The Genesis merger agreement required the presentation of the merger agreement to stockholders for a vote, even after the Board withdrew its favorable recommendation. This combination acted to strip the Board of any further tools to consider a better transaction.

The two-page disposition was issued on an expedited basis to provide "clarity and certainty" to the parties prior to a stockholders meeting slated for later this month. However, the court did announce its intention to issue a more detailed opinion in due course. That opinion will hopefully provide a fuller statement of the law as it regards lock up provisions. For the moment, however, it appears that directors of Delaware corporations should be very wary of any steps that would irrevocably interfere with their flexibility in negotiating merger or sale terms that will yield the highest value to shareholders.

Contact Information

If you would like another copy of this *Information Advisory*, or would like more information, please contact any of the McKenna Long & Aldridge attorneys with whom you regularly work. You may also contact:

[Wayne Bradley](#) at 404.527.4085

[Frank Layson](#) at 404.527.4052

[John Price](#) at 404.527.4672

[Michael Rosenzweig](#) at 404.527.4910

[Tom Wardell](#) at 404.527.4990

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