LOCKING IN THE LOCK-UP?

ORMAN V. CULLMAN & CORPORATE DEAL PROTECTION MEASURES

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In the aftermath of the Delaware Supreme Court's controversial ruling in *Omnicare, Inc. v. NCS Healthcare, Inc.*,[1] corporate attorneys speculated as to whether and to what extent Delaware courts would scrutinize and/or disable the deal protection measures and corporate defense mechanisms their clients' companies put in place to thwart would-be raiders. In *Omnicare*, the Delaware Supreme Court narrowly ruled that a company's board of directors cannot irrevocably agree to sell itself, but rather must retain the right to accept a higher competing offer.[2] This ruling placed strict limitations on the ability of boards of directors to sell a company registered in Delaware, a central issue in the state in which most American public companies are registered.[3]

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1. 818 A.2d 914 (Del. 2003).
2. *Id.* at 915.
3. More than half a million business entities have their legal home in Delaware, including more than 50% of all U.S. publicly-traded companies and 58% of the Fortune 500. *See State of Delaware Department of State—Division of Corporations* (Mar. 10, 2005), *available at* http://www.state.de.us/corp. Delaware is well-known as a corporate haven. Many major corporations are chartered in Delaware because the state charges no corporate income tax on companies not operating within the state—although all Delaware corporations must pay an annual corporate franchise tax. Moreover, Delaware's laws, particularly the Delaware General Corporation Laws, are designed to allow maximum flexibility to corporate operations. Under Delaware law, a corporation need not have a physical presence in the state, save for a registered agent to accept service of legal process and pay the corporation's annual franchise taxes, and officers and directors do not have to reside in the

In late 2004, corporate attorneys had their questions partially answered, as the Delaware Chancery Court limited the holding of *Omnicare*, interpreting the language of the decision in a way that narrowly protected the discretion of boards of directors. In *Orman v. Cullman*,[4] the Chancery Court granted summary judgment in favor of a company's board of directors in a case challenging a lock-up voting agreement used in a "going-private" merger transaction.[5] Specifically, the Chancery Court analyzed an eighteen month lock-up agreement signed by the board of directors with the target's controlling shareholder, which the buyer had required as a condition of the deal. The Chancery Court carefully considered the lock-up, and held that the deal protection measure did not coerce public shareholders into approving the merger.[6] Therefore, the court upheld the lock-up as a legitimate exercise of discretion by the board of directors, and threw the case out.[7]

The decision in *Orman* has various academic and practical implications, as it provides important precedent and crucial guidance from the Delaware courts on how they will analyze other companies' deal protection devices using the standards enunciated in *Omnicare*. Based on the decision, corporate managers, boards of directors, and attorneys can better understand which devices are generally acceptable under Delaware law, and under what circumstances implementation of such protective measures will be upheld.

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state. *See Delaware Corporation*, NATIONMASTER.COM, *available at* http://www.nationmaster.com/encyclopedia/Delaware-corporation (Nov. 20, 2004).

4. 2004 WL 2348395 (Del. Ch. Oct. 20, 2004).

5. *Id.* at *2. "Going-private" is defined as "[t]he repurchasing of all of a company's outstanding stock by employees or a private investor." *See Going Private*, INVESTORWORDS.COM, *available at* http://www.investorwords.com/2192/ going_private.html. As a result of such an initiative, the company stops being publicly traded. Sometimes, the company might have to take on significant debt to finance the change in ownership structure. Companies might want to go private in order to restructure their businesses (when they feel that the process might affect their stock prices poorly in the short run). They might also want to go private to avoid the expense and regulations associated with remaining listed on a stock exchange. opposite of going public. *Id.*

6. *Orman*, 2004 WL 2348395 at *4.

7. *Id.* at *5-6.

Orman also raises important theoretical questions about the powers of corporate boards of directors, and about their fiduciary duties of good faith and loyalty to shareholders. In the aftermath of *Orman*, we must question how paternalistic courts should or must be in their defense of minority shareholders, and to what standards directors should be held accountable for their decisions.

I.
BACKGROUND: DEAL PROTECTION DEVICES

In sophisticated merger and acquisition transactions, there is inevitably a window of time between the public announcement of the acquisition agreement and the closing of the deal.[8] During this interim period—which may last several months or even a year—third party bidders may make a competing offer for a target's shares.[9] Although a higher offer usually means that more consideration is offered to the target's stockholders—and thus may be well received by the market—targets and acquirers often seek to minimize interference from outside parties during the time between the merger agreement and the required stockholder vote.[10] The potential acquiror seeks assurances in the deal because of the "significant sunk costs [it invested] in the initial transaction, including the fees of legal and financial advisors, loan commitments, research and diligence costs, and perhaps most significantly, management time and foregone business opportunities."[11] On the other hand, the target company often seeks to discourage other outside bidders because the proposed merger may present strategic opportunities and advantages that such

8. *See* Sean J. Griffith, *Deal Protection Provisions In The Last Period of Play*, 71 FORDHAM L. REV. 1899, 1900 n.2 (2003). Such a lengthy delay may be caused by the need to obtain regulatory approval and/or shareholder approval. DEL. CODE. ANN. tit. 8, § 251(c) (2005). Stockholder consent entails (at least for public companies) the preparation of a proxy statement and the solicitation of proxies in compliance with federal securities laws, as well as the provision of adequate notice—at least twenty days—before a shareholder meeting. *Id.*

9. Griffith, *supra* note 8, at 1900.

10. *Id.*

11. *Id.*

outside bidders simply cannot match.[12] More importantly, there is always an overarching fear that if the acquiror is able to simply walk away from a potential deal,[13] the target may be left for the sharks; that is, in play without a suitable buyer.[14]

In order to minimize the risks of third-party intervention, merger agreements often include numerous deal protection devices, including lock-up agreements.[15] A brief summary of these devices—specifically those used in the Omnicare and Orman transactions—will shed light on the defenses available to boards of directors of Delaware corporations.[16]

Poison Pills

The poison pill has emerged in recent decades as the most important defense used by corporate boards of directors to protect their companies from unwanted raiders. The implementation of such a defense gives shareholders the right to buy shares of the target,[17] the acquirer[18]—or both—at a substantially discounted price in the event that a single shareholder, or affiliated "group" of shareholders, acquires more than a specified percentage of the company's shares.[19] If trig-

12. *Id. See also* Paramount Communications, Inc. v. Time, Inc., 517 A.2d 1140, 1143 n.4 (Del. 1989) (members of target's outside directors feared that a merger with an entertainment company would divert Time's focus from news journalism and threaten the "Time Culture.").

13. Recent cases have restricted the ability of acquirors to walk away from such deals. *See, e.g., In re* IBP, Inc. S'holders Litig. v. Tyson Foods, Inc., 789 A.2d 14 (Del. Ch. 2001) (where an acquiror was not allowed to abandon its proposed merger with target, because a downturn in the livestock market was not enough to qualify as a "material adverse effect"). *Id.* at 71.

14. Griffith, *supra* note 8, at 1901. A target is considered "in play" when the market knows that it is an acquisition candidate. The announcement of a merger agreement gives outside parties important information regarding the health of the target. *Id.*

15. *Id.* at 1901.

16. Omnicare, 818 A.2d at 914.

17. This type of poison pill arrangement is known as a flip-in provision. *See* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching,* 150 U. PENN. L. REV. 1795, 1815 (2002).

18. This type of poison pill arrangement is known as the flip-over provision. *See id.*

19. Corporate poison pills frequently have different thresholds for the pill to become effective, although most pills call for somewhere between ten and twenty percent of the company's shares to be acquired.

gered, the poison pill provides target shareholders with a stake in the acquirer, or dilutes the potential acquirer's stake in the target, making a hostile takeover more expensive for a prospective raider, and therefore less attractive. The invention of the poison pill has long been credited to NYU School of Law alumnus Martin Lipton, and while theoretically quite powerful, the pill has to date never been deliberately and successfully triggered by a corporate board of directors. Poison pills are usually found in the form of dividends of warrants to purchase company stock, and since the board of a Delaware company has the exclusive authority to issue dividends under sections 157 and 173 of the Delaware General Corporate Law,[20] a pill can be adopted without a shareholder vote. Therefore it is no surprise that virtually every public company has a pill available in its arsenal in case it gets threatened or raided.[21]

The different structures of poison pills have come under attack by various parties, and the Delaware courts have sought to revisit the issue of poison pills for some time. The Chancellors of the Chancery Court seemed ready to take up the issue in the now moot Oracle and Peoplesoft litigation, and may have to wait some time to ultimately decide the fate of the controversial pill.

Litigation regarding the poison pill can be traced all the way back to *Moran v. Household International*, where the Delaware Supreme Court warned corporations that the ability to maintain a poison pill under the *Unocal* standard was not absolute. The court held that: "[t]he ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its shareholders. . . . Their use of the [pill] will be evaluated when and if the issue arises."[22]

In the two decades since *Moran*, the Delaware courts have taken several cases to revisit the prominent place of poison pills among corporate defenses, and specifically invalidated

20. *See* DEL. GEN. CORP. L. §§ 157, 173 (2005); DEL. CODE ANN. tit. 8, §§ 157, 173 (2005).

21. *See* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000).

22. Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

those defensive tactics that were "[un]reasonable in relation to the threat posed" under the *Unocal* standard, affirming that the right to use a pill against a hostile bidder is far from absolute.[23]

In *Paramount Communications v. Time*,[24] the Delaware Supreme Court upheld defensive tactics used by Time to preserve a planned merger between itself and Warner Group, despite a far superior offer from Paramount Communications. The court held that a target company faced with a hostile offer could protect its planned friendly merger "unless there is clearly no basis to sustain the corporate strategy."[25] This has since come to be known as the "Just Say No" defense.[26] In *Unitrin v. American General Corp.*,[27] the Delaware Supreme Court examined *Unocal*'s reasonableness requirement and similarly interpreted it to mean that any defensive tactics—provided they are not "coercive" or "preclusive"—must fall within a "range of reasonable responses."[28]

Greater controversy regarding the poison pill emerged regarding the use of "dead hand" or "slow hand" pills. A dead hand pill contains a provision that allows the pill to be redeemed only by the directors who were elected when the pill was actually adopted, or by their "approved successors." Likewise, a slow hand pill contains provisions that prevent *any* redemption of the pill for a limited period of time after any change in composition of the company's board of directors. Use of both the dead and slow hand pills was struck down by Delaware courts in the last decade, while other states have per-

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23. *See* Paramount Communications v. Time, 571 A.2d 1140 (Del. 1989). *See also* Grand Metropolitan PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988) (enjoining defensive spin-off and requiring redemption of poison pill under the *Unocal* standard); City Capital Assocs. v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988) (enjoining recapitalization and requiring redemption of poison pill under the *Unocal* standard); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989) (enjoining management buyout).

24. 571 A.2d 1140 (Del. 1989).

25. 571 A.2d at 1154 (emphasis added).

26. *See, e.g.*, James C. Freund & Rodman Ward, Jr., *What's 'In,' What's 'Out' in Takeovers in Wake of* Paramount v. Time, NAT'L. L. J. 22, 25 (Mar. 26, 1990).

27. 651 A.2d 1361 (Del. 1995).

28. *Id.* at 1367.

mitted their domestic companies to utilize them.[29] The dead hand pill, in particular, is generally understood to be a complete defense against a hostile takeover bid, and its rejection by Delaware was heralded by many as a step in right direction to protect shareholders and ensure that boards of directors will seek the highest price for their constituents.

Termination Fees

A termination fee provision is an agreement between the target and acquiror that provides that if the proposed transaction fails due to the fault of either party, the party walking away from the deal must pay a specified termination fee.[30] Although there is no standard termination fee, Delaware courts have consistently upheld termination fees amounting to two to four percent of the deal value as both "reasonable" and not "coercive" to shareholders.[31] Reasonable termination fees are "designed to protect the transaction for the acquiror, to make it more expensive for any third party to enter the bidding after

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29. *See* Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998) (invalidating dead hand pill); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998) (invalidating slow hand pill). *See also* VA. CODE ANN. § 13.1-646(B) (2002); Chesapeake Corp. v. Shore, 771 A.2d 293, 302 (Del. Ch. 2000); PA. CONS. STAT. tit. 15, § 611 (2004); AMP Inc. v. Allied Signal Inc., No. 98-4405, 1998 U.S. Dist. LEXIS 15617, at *34-35 (E.D. Pa. Oct. 8, 1998); GA. CODE ANN. § 14-2-624(c) (2004); Invacare Corp. v. Healthdyne Technologies, Inc., 968 F. Supp. 1578 (N.D. Ga. 1997); MD. CODE ANN. CORPS. & ASS'NS § 2-201(c)(2)(ii) (Supp. 2004) (allowing directors to limit the power of future directors to vote for redemption, modification, or termination of a pill for up to 180 days).

30. Termination fees are also commonly referred to as "bust-up" fees or "break-up" fees. *See* Lou R. Kling & Eileen Nugent Simon, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES, AND DIVISIONS § 13.05[2] (1997). *See also* Comment, *Breaking-Up is Hard to Do: A Look at* Brazen v. Bell Atlantic *and the Controversy over Termination Fees in Mergers and Acquisitions,* 65 BROOK L. REV. 585 (1999) (analyzing courts' decisions to review termination fees under the business judgment rule or the liquidated damages test).

31. Brazen v. Bell Atl. Corp., 695 A.2d 43, 50 (Del. 1997) ("Wrongful coercion that nullifies a stockholder vote may exist 'where the board or some other party takes actions which have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction.'"). *See also* Phelps Dodge Corp. v. McAllister, C.A., No. 17398, 1999 Del. Ch. LEXIS 202, at *5 (Del. Ch. Sept. 27, 1999) ("6.3 percent certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point").

an agreement has been announced, and to ensure the initial putative acquiror that it will be appropriately compensated" if the deal were to deteriorate.[32]

Historically, Delaware courts have relied on the business judgment rule to determine whether a termination fee is "reasonable."[33] In most cases adjudicating the reasonableness of such fees, the courts have used a liquidated damages analysis.[34] That test was outlined by the Delaware Supreme Court in *Brazen v. Bell Atlantic Corp.*,[35] and requires that damages that would result from the breach of a merger agreement must be uncertain or incapable of accurate calculation;[36] and that the termination fee must be a "reasonable forecast of actual damages," and not merely a penalty intended to punish the stockholders for not approving the merger.[37] Thus, if the damages cannot be calculated accurately and the termination fee is reasonable, this section of the agreement would be considered valid.

As a general rule in Delaware, termination fees are upheld so long as the amount provided is not unreasonably high and stockholders are not coerced into voting in favor of the transaction because of the severity of the termination fee if they were to vote against it.[38]

No-Shop Clauses

No-Shop clauses are also frequently used by parties engaged in merger negotiations, to prevent third-party bidders from intervening in such negotiations.[39] One common way of commencing negotiations is for the boards of the target and

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32. Simon M. Lorne, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 2:23 (2003).

33. *See generally Brazen*, 695 A.2d at 49-50 (ruling that a liquidated damages analysis should be utilized in analyzing termination fees). *See also infra* notes 51-58 and accompanying text.

34. *Id.* This represents the anticipated loss by either party should the merger not take place. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. B (2005).

35. *Brazen*, 695 A.2d at 49-50.

36. *Id.* at 48.

37. *Id.*

38. *See generally* Coates, *supra* note 21, at 331-36 (discussing recent trends in termination fees).

39. *See* Lorne, *supra* note 32, § 2.24.

acquiror to sign a "standstill" agreement, also referred to as an "exclusivity agreement."[40] The exclusivity agreement is a contract signed by both parties to the negotiations before the definitive merger agreement is even drafted that restricts the ability of the target to negotiate with an outside party.[41] It usually provides that the target may negotiate with the acquiror for a specified period of time, typically two or three weeks.[42] This agreement usually demands that the target will not directly or indirectly solicit new merger or acquisition proposals from any company or group other than the prospective acquiror, provide any non-public information to any outside third party, entertain any proposal from such a party, and agree that it will not disclose to the public that private negotiations are taking place.[43] Because of the short window of the standstill agreement, "fiduciary out" provisions are generally not included in this exclusivity agreement.[44]

When the target and acquiror agree to sign a definitive merger agreement, the acquiror often includes a provision similar to the standstill agreement that prevents the acquiring company from being a "stalking horse" for other bidders.[45] This provision is similar to the exclusivity agreement in that it prevents the target from engaging in discussions with third parties concerning an alternative acquisition.[46]

The principal distinction between the "no-shop" provision contained within the merger agreement and the exclusivity agreement is the inclusion of a "fiduciary out" clause.[47] The latter allows the target to communicate with a third party if the

40. *Negotiating Acquisitions of Public Companies,* 10 U. MIAMI BUS. L. REV. 219, 221 (2002).

41. *Id.*

42. *Id.* at 229-30.

43. *Id.* at 273-74.

44. *Id.* at 231-32.

45. The term "stalking horse" refers to an acquiror's initial bid which is then used by the target to attract higher offers. *In re* Integrated Res., Inc., 147 B.R. 650, 661 (S.D.N.Y. 1992).

46. Kling & Simon, *supra* note 30, § 13.05[1].

47. A fiduciary-out clause has its basis in the restrictions placed on fiduciaries so that they are not induced into violating their duty to beneficiaries. RESTATEMENT (SECOND) OF CONTRACTS § 193 (2005). The section heading states: "A promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy." *Id.*

target's board determines that such discussions are required by its fiduciary duties to stockholders.[48] In addition, the Chancery Court has held that a target's board must be fully informed before agreeing to a "no-shop" provision, or otherwise it may breach its fiduciary duties by foreclosing on a better opportunity.[49]

Typically, the "fiduciary out" clause authorizes the target's board of directors to speak with other bidders only if the board concludes "in good faith. . . based on the written advice of its outside legal counsel, that participating in such negotiations or discussions or furnishing such information is required in order to prevent the Board of Directors. . . from breaching its fiduciary duties to its stockholders."[50]

II.
JUDICIAL SCRUTINY OF DEAL PROTECTION PROVISIONS

To decipher the complex reasoning of the *Omnicare* and *Orman* decisions, it is important to have a basic understanding of how Delaware courts review decisions by boards of directors. This section provides a summary of the seminal cases that have formed the backbone of judicial review of a board's decision under Delaware law.

The Business Judgment Rule

Shareholders who are unhappy with the terms of a merger agreement may sue the board of directors of the company claiming that it violated its fiduciary duties of care, loyalty, and/or good faith.[51] Delaware courts traditionally apply the business judgment rule in determining whether boards of directors violated these duties to shareholders.[52] The business judgment rule is basically a judicial presumption that "in making a business decision the directors of a corporation acted on

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48. *See* Kling & Simon, *supra* note 30, § 13.05[1].

49. *See* Phelps Dodge Corp. v. McAllister, No. 17398, 1999 Del. Ch. LEXIS 202, at *3-4 (Del. Ch. Sept. 27, 1999) ("even the decision not to negotiate . . . must be an informed one").

50. ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 98 (Del. Ch. 1999).

51. *See* DEL. CODE. ANN. tit. 8, § 262 (2003). In the alternative, such dissatisfied shareholders may seek to exercise their appraisal rights. *Id.*

52. Franklin A. Gevurtz, CORPORATION LAW § 7.2, at 654 (2000). Such a challenge may involve a duty of care or duty of loyalty claim. *Id.*

an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[53] Thus, any party attacking a decision of a corporate board of directors as "uninformed" must rebut the presumption that its business judgment was an informed one.[54] The determination of whether a decision is "informed" or "uninformed" ultimately hinges on whether the directors educated themselves regarding all material information reasonably available to them prior to making their decision.[55]

The seminal case with regard to the business judgment rule in the context of mergers and acquisitions is *Smith v. Van Gorkom*,[56] where the Delaware Supreme Court held that the directors of a target company breached their fiduciary duties by failing to inform themselves of all information reasonably available to them, and failing to disclose all material information that a reasonable stockholder would consider important in deciding whether to approve the offer.[57]

The business judgment rule is important to plaintiffs because absent a showing of bad faith or uninformed decision making, a court will not probably hold directors liable for their decisions, even if they are poor ones that materially and adversely affect the corporation's value.[58]

The Unocal *Standard: Enhanced Scrutiny*

The business judgment rule gives broad discretion to a company's board of directors in making strategic and managerial decisions on behalf of the corporation.[59] In the context of mergers and acquisitions, this discretion can become rather complicated.[60] When confronted with a possible change in corporate control, a company's board of directors has an obligation to determine whether the offer is in the best interests of the corporation and its stockholders.[61] In hostile takeovers, directors may face numerous conflicts of interest, such as the

53. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
54. *Id.*
55. *Id.*
56. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).
57. *Id.* at 893.
58. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).
59. *See supra* notes 50-58 and accompanying text.
60. *See infra* notes 71-80 and accompanying text.
61. *Unocal*, 493 A.2d at 955.

possibility of losing their position on the board.[62] In *Unocal v. Mesa Petroleum Co.*,[63] the Delaware Supreme Court held:

> Because of the omnipresent specter [in takeover cases] that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.[64]

With this in mind, when a board might be tempted to further its own interests ahead of the interests of the stockholders, enhanced judicial scrutiny may be triggered.[65]

Unocal formulated a two-part test which courts use to review directors' decisions to employ takeover defenses before they would come within the ambit of the business judgment rule.[66] First, the directors must show reasonable grounds for believing that a danger to corporate policy and effectiveness existed.[67] Second, the defensive measures implemented must be reasonable in relation to the threat posed.[68]

The *Unocal* standard, unlike the business judgment rule, shifts the burden of proof to the directors to show a justification for their decision.[69] In addition, because the defensive measures adopted must be "reasonable" in proportion to the perceived threat, courts use an objective inquiry when reviewing takeovers, unlike the more deferential presumption of the business judgment rule.[70]

The Revlon *Standard: Heightened Scrutiny*[71]

Delaware's most demanding standard was announced and explained in *Revlon v. MacAndrews and Forbes Holdings, Inc.*,

62. *Id.*
63. *Id.* at 946.
64. *Id.* at 954.
65. *Id.*
66. *Id.* at 955.
67. *Unocal*, 493 A.2d at 955. The first part of the *Unocal* test was first crafted in Cheff v. Mathes, 199 A.2d 548, 554-55 (Del. 1964).
68. *Unocal*, 493 A.2d at 955.
69. *Id.*
70. *Id.*
71. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

where Revlon tried to ward off a hostile acquiror, by seeking the assistance of a "white knight".[72] Prior to signing any definitive merger agreement, Revlon's Board of Directors adopted a number of defensive tactics, including a stockholder rights (poison pill) plan,[73] as well as a share repurchase plan.[74]

Yet, the hostile bidder continued to incrementally increase its bid.[75] In the end, Revlon signed a merger agreement with a "white knight" that included several deal protection provisions.[76] The Delaware Supreme Court first held that Revlon's defensive measures prior to the merger agreement were reasonable in relation to the threat posed under the *Unocal* analysis.[77] Nevertheless, the court held that as the hostile bidder kept increasing its offer, "it became apparent to all that the break-up of the company was inevitable," and as such, "the duty of the board had thus changed from the preservation of Revlon as a corporate entity" to that of "auctioneers charged

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72. A "white knight" is an acquiror preferred by the board "that rescues the target of an unfriendly corporate takeover, especially by acquiring a controlling interest in the target corporation or by making a competing tender offer." BLACK'S LAW DICTIONARY 1591 (7th ed. 1999). *See also* Revlon, 506 A.2d at 175-78.

73. *Revlon,* 506 A.2d at 177. The court provided:

> Under this plan, each Revlon shareholder would receive as a dividend one Note Purchase Right (the Rights) for each share of common stock, with the Rights entitling the holder to exchange one common share for a $ 65 principal Revlon note at 12% interest with a one-year maturity. The Rights would become effective whenever anyone acquired beneficial ownership of 20% or more of Revlon's shares, unless the purchaser acquired all the company's stock for cash at $ 65 or more per share. In addition, the Rights would not be available to the acquiror.

Id.

74. The Revlon board voted to repurchase up to ten million of its nearly thirty million outstanding shares. *Id.*

75. *Id.* Pantry Pride's first cash tender offer on August 23, 1985 was "for any and all shares of Revlon at $47.50 per common share and $26.67 per preferred share . . . ." *Id.* By October 7, 1985, Pantry Pride was offering $56.25 for each common share. *Id.* at 178.

76. *Id.* The provisions included were a no-shop provision and an asset lock-up which gave Forstmann the right to purchase Revlon's VisionCare and National Health Laboratories divisions for $525 million, some $100-175 million below the market value, if another acquiror obtained 40 percent of Revlon's outstanding shares. *Id.* at 178.

77. *Id.* at 181.

with getting the best price for the stockholders at a sale of the company."[78]

Over time, a board's duty to obtain the highest price for stockholders has become known as its *Revlon* duty.[79] Circumstances which give rise to this heightened judicial scrutiny occur when there is a change in the control of a corporation, the corporation "initiates an active bidding process seeking to sell" the company, and the "break up of the corporate entity is inevitable."[80]

III.
OMNICARE

The *Omnicare* litigation was spawned by Omnicare's proposed takeover of NCS Healthcare, Inc., a Delaware corporation, which called itself a "leading independent provider of pharmacy services to long-term care institutions including skilled nursing facilities, assisted living facilities and other institutional healthcare facilities."[81] In 1999, NCS experienced financial difficulty, which led to a sharp decline in its stock price.[82] In response to the company's instability, NCS creditors formed an *ad hoc* committee to protect their financial interests.[83] After extensive investigation,[84] NCS was unable to obtain any offers that would fully reimburse its creditors and also supply any sort of compensation to the stockholders.[85] In April 2001, NCS was in default on approximately $350 million in debt, including senior bank debt and notes outstanding under convertible subordinated debentures.[86]

78. *Id.* at 182.

79. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 928 (Del. 2003).

80. *Id.*

81. *Id.* at 918.

82. *Id.* NCS's stock dropped from $20 in January 1999 to $5 by the end of the year. *Id.* at 920.

83. Id. at 921.

84. *Id.* at 920. In February 2000, NCS hired UBS Warburg, L.L.C. to look for strategic alternatives. Over fifty different entities were contacted, but only one indication of interest surfaced for $190 million, substantially less than the outstanding notes. *Id.*

85. *Id.*

86. *Id.*

In mid-2001, NCS contacted Omnicare to discuss a possible transaction.[87] After initial discussions, Omnicare proposed to acquire NCS in a bankruptcy sale for $225 million, subject to completion of standard due diligence.[88] After further negotiations, Omnicare eventually offered $270 million, but still demanded to make the acquisition in a bankruptcy sale.[89] After careful consideration, NCS determined that Omnicare's offer was inadequate, because it did not provide full recovery for the bondholders or any recovery for its stockholders.[90]

In January 2002, after the failed negotiations with Omnicare, the *ad hoc* committee began discussions with Genesis, a company that provided healthcare and support services to the elderly.[91] During these negotiations, NCS's operating performance began to improve and its corporate directors began to believe that its equity owners may receive some compensation after all.[92] In June 2002, therefore, Genesis wrote a proposal for a deal that included repayment of the NCS senior debt in full, payment of par value for the short-term outstanding notes (*without* accrued interest) in the form of a combination of cash and Genesis stock, payment of $24 million in Genesis stock to NCS shareholders, and the assumption of additional liabilities to certain creditors.[93]

Genesis also demanded that NCS agree to an exclusivity agreement,[94] and that the merger agreement have a "force-the-vote provision" authorized under § 251(c) of the Delaware Corporation Law.[95] This provision would require NCS to sub-

87. *Id.* at 919-21. Omnicare is an institutional pharmacy business incorporated in Delaware with its principal place of business in Covington, Kentucky. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.* at 922.

93. *Id.* at 923.

94. *Id.* at 924. This agreement precluded NCS from "engaging or participating in any discussions or negotiations with respect to a Competing Transaction or a proposal for one." *Id.*

95. DEL. CODE ANN. tit. 8, § 251(c) (2005) ("the terms of the agreement may require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it").

mit the agreement to a stockholder vote, even without the board's recommendation.[96] It also included a provision requiring two board members, John Outcalt[97] and Kevin Shaw[98]—who collectively owned more than 65% of the shares outstanding—to vote their shares in favor of the transaction.[99] In effect, the force-the-vote provision, together with this voting agreement, was an attempt to lock-in the merger agreement regardless of whether the board later rescinded its recommendation.

The exclusivity agreement was signed in early July 2002 and negotiations continued between NCS and Genesis regarding the proposed merger.[100] The exclusivity agreement was authorized through July 31, 2002.[101]

Toward the end of July 2002, Omnicare began suspecting that the run-up in the price of NCS's stock was attributed to NCS negotiating with Genesis or one of its other competitors.[102] Believing that this could potentially pose a competitive threat, Omnicare began to reconsider NCS as a viable acquisition candidate.[103]

Omnicare faxed NCS a letter on July 26, 2002 outlining a proposed acquisition.[104] The proposal suggested an acquisition whereby "Omnicare would retire NCS's senior and subordinated debt at par *plus* accrued interest, and pay the NCS stockholders $ 3 cash for their shares."[105] Omnicare's offer was expressly conditioned on its completing due diligence.[106]

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96. *Omnicare,* 818 A.2d at 923.

97. *Id.* at 918. John Outcalt was Chairman of the NCS board of directors. Outcalt owned 202,063 shares of NCS Class A common stock and 3,476,086 shares of Class B common stock. The Class B shares were entitled to ten votes per share and the Class A shares were entitled to one vote per share.

98. *Id.* at 919. Kevin Shaw was President, CEO, and director of NCS. Shaw owned 28,905 shares of NCS Class A common stock and 1,141,134 shares of Class B common stock." *Id.*

99. *Id.* at 923.

100. *Id.* at 923-24.

101. *Id.* at 923.

102. *Id.* at 924.

103. *Id.*

104. *Id.*

105. *Id.* (emphasis added).

106. *Id.*

The exclusivity agreement with Genesis notwithstanding, the Board of NCS met to consider the Omnicare proposal.[107] They concluded that although the terms of the offer were better than that of Genesis, its due diligence requirement "substantially undercut its strength."[108] An independent committee of NCS "concluded that discussions with Omnicare about its July 26 letter presented an unacceptable risk that Genesis would abandon merger discussions."[109]

After learning of Omnicare's proposal, Genesis improved its offer on July 27 to include paying off the defaulted notes in accordance with the terms of the indenture, increasing the exchange ratio that NCS stockholders would receive by 80% and lowering the proposed termination fee from $10 million to $6 million.[110] In return for these better terms, however, Genesis stipulated that the transaction had to be approved by midnight the next day, July 28, and if that demand was not met, Genesis would terminate discussions and withdraw its offer completely.[111]

On July 28, both the independent committee and the Board of Directors of NCS met and concluded that Genesis was sincere in establishing the midnight deadline.[112] The committee met first and voted unanimously to recommend the transaction to the board.[113] The full board of directors for NCS met next, and after receiving advice from its legal and financial advisors, concluded that "balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's [revised] letter, resulted in the conclusion that the only reasonable alternative for the Board of Directors [was] to approve the Genesis transaction."[114] The merger agreement between NCS and Genesis was executed later that day.[115]

107. *Id.*
108. *Id.*
109. The underlying fear of the target corporation in these situations is that market forces may view the failed transaction as being caused by weaknesses in the target corporation's financial condition. If this happens, lenders may be more reluctant to enter into long term contracts and the stockholders may begin to sell their shares in response. *Id.*
110. *Id.* at 924-25.
111. *Id.* at 925.
112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.*

The Merger Agreement

The merger agreement between NCS and Genesis contained several pertinent provisions. First, NCS stockholders would receive one share of Genesis common stock in exchange for every ten shares of NCS common stock they held. As per Delaware Corporation Law, NCS stockholders were allowed to exercise their appraisal rights after the transaction was effected.[116] NCS agreed to redeem its short-term notes in accordance with the contractual terms, and to submit the merger agreement to NCS stockholders regardless of whether the Board of Directors continued to recommend the merger. NCS also agreed that it would not enter into discussions with third parties concerning an alternative acquisition of the company, or provide non-public information to such parties, unless the third party provided an unsolicited, *bona fide* written proposal documenting the terms of the acquisition, the NCS board believed in good faith that the proposal was or was likely to result in an acquisition on terms superior to those contemplated by the NCS/Genesis merger agreement, and that before providing non-public information to any third party, that third party would be required to execute a confidentiality agreement at least as restrictive as the one in place between NCS and Genesis. If the merger agreement were to be terminated, NCS would be required to pay Genesis a $6 million termination fee and/or Genesis's documented expenses, up to $5 million.[117]

In conjunction with the merger agreement, Outcalt and Shaw consented to sign the voting agreements.[118] These agreements provided that neither director would transfer their shares prior to the stockholder vote on the merger agreement, and that both agreed to vote all of their shares in favor of the

116. *See* DEL. CODE ANN. tit. 8, § 262 (2005).

117. *Id.* at 925-26.

118. *Id.* Omnicare's initial argument at the Court of Chancery was that these voting agreements violated a clause in NCS's Certificate of Incorporation that prevented any person holding any shares of Class B Common Stock from transferring their shares to any person other than a "Permitted Transferee." Omnicare v. NCS Healthcare, Inc., 825 A.2d 264, 268-69 (Del. Ch. 2002). The Chancery Court concluded that the voting agreement signed by Outcalt and Shaw did not transfer their ownership interest, but simply expressed their promise to vote those shares in a particular manner in an effort to induce Genesis to enter into a merger agreement with NCS. *Id.* at 271-72.

merger agreement. Both also granted to Genesis an irrevocable proxy to vote their shares in favor of the merger agreement.[119]

Omnicare Strikes Back

The day following the execution of the merger agreement, Omnicare faxed to NCS a letter reiterating its $3.00 per share offer along with a draft merger agreement.[120] Later that morning, Omnicare disclosed in a press release its proposal to acquire NCS.[121]

On August 1, 2002, Omnicare decided to increase its offer to the stockholders of NCS and announced that it intended to launch a tender offer for NCS's shares at a price of $3.50 per share.[122] It also filed a lawsuit seeking to enjoin the merger agreement between NCS and Genesis.[123] After obtaining a waiver from Genesis,[124] the NCS board met with Omnicare, which agreed to drop its due diligence clause thus "irrevocably committing itself to a transaction with NCS."[125] In light of Omnicare's new and superior offer, the NCS board voted to withdraw its recommendation that NCS stockholders approve the NCS/Genesis merger agreement.[126]

Although the executed merger agreement between NCS and Genesis allowed NCS to talk to a third party bidders if certain conditions were met, the effects of these talks would be moot since NCS and Genesis were assured of consummation.[127] The July 28 merger agreement used the force-the-vote provision combined with Outcalt and Shaw's voting agreements to mathematically lock-in Genesis' acquisition of

119. *Id.* at 926.

120. *Id.* at 926-27.

121. *Id.* at 926.

122. The $3.50 per share tender offer was more than twice the value that NCS would have received from the deal with Genesis. *Id.*

123. *Id.*

124. The directors of NCS needed to obtain a waiver because they were unsure whether discussions with Omnicare would lead to a superior proposal as was required by the merger agreement before NCS could have discussions with third parties. *See id.* at 925-26.

125. *Id.* at 926.

126. *Id.*

127. *Id.* at 927.

NCS.[128] As a result, Omnicare and NCS stockholders commenced litigation seeking to enjoin the merger between NCS and Genesis.[129]

The Delaware Supreme Court began its analysis by determining which standard of judicial review should apply to the NCS board's decision to merge with Genesis.[130] The court believed that "*Revlon* duties had not been triggered because NCS did not start an active bidding process, and the NCS board 'abandoned' its efforts to sell the company when it entered into an exclusivity agreement with Genesis."[131] In the end, the court agreed with the Chancery Court's conclusion that the decision to merge should be analyzed under the business judgment rule.[132]

After holding that the business judgment rule applied, the court distinguished the decision to merge with Genesis and the decision to adopt deal protection devices into the merger agreement.[133] As a consequence, the court held that the protection devices themselves should not be analyzed under the business judgment rule, but rather the enhanced judicial scrutiny required under the *Unocal* standard.[134]

Under the *Unocal* standard, the court held that the defensive measures drafted into the merger agreement failed to satisfy the second prong's "proportionality" test.[135] The court

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128. *Id.*

129. *Id.*

130. *Id.* at 928.

131. *Id.* at 929. The Chancery Court held that even if *Revlon* applied, the directors still acted in conformity with their fiduciary duties in seeking to achieve the best price reasonably available to the stockholders. *See In re* NCS Healthcare, Inc., No. CIV.A.19786, 2002 WL 31720732, at *16 (Del. Ch. Nov. 22, 2002).

132. *Omnicare,* 818 A.2d at 929. The court assumed arguendo that the business judgment rule applied to the decision by the NCS board to merge with Genesis. *Id.*

133. *Id.* at 930.

134. *Id.* at 930-31. In justifying this decision, the court analogized *Paramount Communication, Inc. v. Time, Inc.,* 571 A.2d 1140 (Del. 1989), where the business judgment rule applied to the merger decision of the Board of Directors of Time, but the defensive devices adopted by the board to protect the original merger transaction were scrutinized under the *Unocal* standard. *Id.*

135. *Id.* at 935. The second part of *Unocal* requires that defensive responses must be "reasonable in relation to the threat posed." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

found that NCS's Board of Directors did not adopt reasonable protection devices because the combined effect of having a force-the-vote provision, stockholder voting agreements, and the absence of an effective fiduciary out clause were "coercive" and "preclusive."[136] The devices were "coercive" because the minority stockholders of NCS— even though theoretically not forced to vote for the Genesis merger—were required to accept it because it was a "*fait accompli.*"[137]

The court declared that an effective "fiduciary out" is required when a merger agreement has both a force-the-vote provision and a voting agreement signed by owners with a majority of voting power.[138] It held that when the majority of a company's shares are acting as a cohesive group, the "minority stockholders must rely for protection solely on the fiduciary duties owed to them by the directors."[139] The court reasoned that the board of directors could not delegate its fiduciary duties to the stockholders to approve or disapprove of the merger agreement because the subsequent stockholder vote was moot given that a majority voting agreement had already been signed.[140]

While the court acknowledged that § 251(c) of the Delaware General Corporation Law allows a stockholder vote regardless of whether the directors approve or disapprove of the merger agreement,[141] it recognized that the statute could not limit the directors' fiduciary duties or prevent the NCS directors from carrying out their fiduciary duties under Delaware law.[142] The court held that directors, even after a merger agreement has been announced, have a "continuing obligation to discharge their fiduciary responsibilities, as future cir-

136. *Omnicare,* 818 A.2d 933-35. A protection device "is 'coercive' if it is aimed at forcing upon stockholders a management-sponsored alternative to a hostile offer." *Id.* at 935. The court ruled that "[a] response is 'preclusive' if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise." *Id. See also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387 (Del. 1995).

137. *Id.* at 936.

138. *Id.* at 936-37.

139. *Id.* at 937 (quoting Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994)).

140. *Id.*

141. DEL. CODE. ANN. tit. 8, § 251(c) (2005).

142. *Omnicare,* 818 A.2d at 938.

cumstances develop."[143] Therefore, the court ruled that NCS's Board of Directors violated their fiduciary duties by not including an effective fiduciary out provision in the merger agreement with Genesis.[144]

The Dissenting Opinions

Two dissenting opinions—written by Chief Justice Norman Veasey and Justice Myron T. Steele[145]—argued that the majority diverged from precedent and adopted a new rule that a "merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up stockholder approval and does not contain a 'fiduciary out' provision, is *per se* invalid when a later significant topping bid emerges."[146] The dissenting justices believed this new rule was an "unwise extension of existing precedent."[147]

The dissent argued that the decision by NCS to merge with Genesis must be viewed in "real-time" before the merger agreement was entered.[148] They believed that lock-ups should not be viewed in a vacuum,[149] but instead, should be reviewed considering the entire bidding process, to determine whether the independent board's actions permitted the directors to inform themselves of their available options and whether they acted in good faith.[150] Since the NCS Board of Directors fulfilled its duties of care, loyalty, and good faith by entering into the Genesis merger agreement, the dissent reasoned that the court should not analyze the board's decision *ex post* in light of a higher bid from Omnicare.[151]

The dissenting justices also argued that the majority misapplied prior case law in its analysis of coercive and preclusive measures.[152] The dissent believed that:

143. *Id.* at 938.

144. *Id.*

145. *Id.* at 939-50. Chief Justice Veasey wrote a dissenting opinion in which Justice Steele joined. *Id.* at 939-46. Justice Steele wrote a separate dissenting opinion to elaborate on his central objections. *Id.* at 946-50.

146. *Id.* at 942.

147. *Id.* at 943.

148. *Omnicare,* 818 A.2d at 940.

149. *Id.* at 941.

150. *Id.*

151. *Id.* at 946.

152. *Id.* at 943-44.

> [T]he deal protection measures were not adopted unilaterally by the board to fend off an existing hostile offer (as was the situation in *Unitrin, Inc. v. American General Corp.*). They were adopted because Genesis—the 'only game in town'—would not save NCS, its creditors and its stockholders without these provisions.[153]

The dissenters argued that the "draconian" measures in *Unitrin*[154] "dealt with unilateral board action. . . designed to fend off an existing hostile offer by American General."[155] The dissenters also argued that a bright-line test might deter corporate bidders from engaging in negotiations if there must always be a "fiduciary out" clause.[156] The dissent stressed that such a rule may reduce the number of wealth-enhancing transactions.[157] This is because, as the dissenters stated:

> [A] lock-up permits a target board and a bidder to 'exchange certainties.' Certainty itself has value. The acquiror may pay a higher price for the target if the acquiror is assured consummation of the transaction. The target company also benefits from the certainty of completing a transaction with a bidder because losing an acquiror creates the perception that a target is damaged goods, thus reducing its value.[158]

With this in mind, the dissent suggested that in some instances, certainty is not only desired, but can also add significant value to the transaction.[159]

Justice Steele, in his separate dissenting opinion, argued that the majority wrongfully applied the *Unocal* standard and that the business judgment rule was the proper standard of judicial review when a board of directors' decision is made with good faith, using due care, and is not tainted by any self-dealing.[160] He wrote that "Delaware corporate citizens now face the prospect that in *every* circumstance, boards must ob-

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153. *Omnicare*, 818 A.2d at 943-44.
154. *Unitrin*, 651 A.2d at 1370.
155. *Omnicare*, 818 A.2d at 944.
156. *Id.* at 946.
157. *Id.* at 942.
158. *Id.*
159. *Id.*
160. *Id.* at 946-47.

tain the highest price, even if that requires breaching a contract entered into at a time when no one could have reasonably foreseen a truly 'Superior Proposal.'"[161]

IV.
ORMAN: A NARROW INTERPRETATION OF *OMNICARE*

Orman v. Cullman followed *Omnicare* and continued its analysis of lock-up agreements. *Orman* involved the Delaware company General Cigar, which was (at one time) the largest manufacturer of brand-name premium cigars in the United States.[162] The company was founded by the Cullman family, which maintained a substantial ownership of one class of the company's stock, and retained voting power over the company through their ownership of another class of stock which provided supervoting powers.[163] By voting these shares, the Cullmans were able to keep certain family members on the Board of Directors of General Cigar, and even comprised certain positions in management of the company.[164]

In late 1999, Swedish Match expressed interest in acquiring General Cigar, but indicated that it wanted two of the Cullmans to continue in their roles managing the daily affairs of the company.[165] General Cigar formed a Special Committee of disinterested directors to consider any offer by Swedish Match.[166]

Swedish Match proposed a merger with General Cigar, that provided that the Cullmans would sell a portion of their Class A stock to Swedish Match for $15 per share, followed by a merger of General Cigar into a Swedish Match subsidiary. Public shareholders would also receive $15 per share.[167] After the merger, the subsidiary company would be owned primarily by Swedish Match, but the Cullmans would retain voting control.[168]

161. *Id.* at 948.
162. *Orman*, 2004 WL 2348398 at *1.
163. *Id.* at *2.
164. *Id.* at *1.
165. Specifically, Swedish Match wanted Edgar M. Cullman, Sr. and Edgar M. Cullman, Jr. to maintain management responsibility and day-to-day control of General Cigar. *Id.*
166. *Id.* at *2.
167. *Id.* at *2-3.
168. *Id.* at *2.

In offering its proposal, Swedish Match required the Cullman family to enter into a voting arrangement (similar to that in *Omnicare*) that would protect Swedish Match against the risk that the General Cigar would shop its offer to other bidders.[169] Under the proposed agreement, the Cullmans would agree to refrain from selling their shares, and contracted to vote their shares against *any* alternative bid for the company for a specified period of time.[170]

Because the Cullmans maintained a controlling interest in the voting shares of General Cigar, the agreement would effectively prevent alternative bidders from acquiring control of the company during the specified period. This protection was particularly important to Swedish Match because the proposed merger agreement did not include any termination fees or expense reimbursement provisions.[171]

The merger agreement did not restrict General Cigar's Board of Directors from considering any unsolicited acquisition proposals from third parties if the board determined that the proposal was *bona fide* and would be more favorable to the public shareholders than Swedish Match's proposal.[172] The agreement also contained a provision allowing General Cigar's Board of Directors to withdraw its recommendation if it concluded that its fiduciary duties so required.[173] However, due to a force-the-vote provision (also like that in *Omnicare*), General Cigar would still be required to submit the proposal to its shareholders.

Notably, the proposed transaction was also expressly subject to majority of the minority approval, and therefore, it could not be closed unless a majority of the Class A shareholders approved it.[174] This, in essence, gave the shareholders a veto over the proposed merger.

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169. *Id.* ("A central purpose of the voting agrement was to protect Swedish Match against the risk that the Cullmans or General Cigar would "shop" Sweidsh Match's offer to other potential bidders."). As described above, this technique is referred to as a "stalking-horse." *See supra* note 45 and accompanying text.

170. *Id.*

171. *Id.*

172. *Id.* at *3.

173. *Id.*

174. *See id.* at *3. The public shareholders were not in fact a "minority" because the Cullmans held less than a majority of the public shares. How-

The Special Committee negotiated an increased price of $15.25 per share for the public shareholders, but not the Cullmans, who would still receive $15 per share.[175] This price represented a premium of more than 76 percent over the trading price at the time. In exchange for this increase in price, Swedish Match required the Cullmans to increase the period under the voting agreement from one year to eighteen months. The Special Committee and the Cullmans agreed to this change.[176]

The Special Committee and the Board of Directors both voted to approve the merger, and the deal was publicly announced on January 20, 2000.[177] The proxy materials relating to the shareholder vote were filed several months later, and a shareholders' meeting was held on May 8, 2000, where the public shareholders voted overwhelmingly in favor of the proposal.[178]

The Litigation Ensues

Orman filed a shareholder class action suit, claiming that General Cigar's Board of Directors breached its fiduciary duties in approving the merger, and alleging that the price paid to shareholders was unfair.[179] Plaintiffs also alleged that there were several deficiencies in the proxy materials, and that the shareholder vote was therefore not "fully-informed."[180]

The court dismissed all but one of the plaintiffs' disclosure claims, and found that the remaining claim presented factual issues that would require discovery.[181] Defendants moved for summary judgment on that disclosure claim, and Orman withdrew the claim. Defendants then moved for summary judgment on plaintiffs' fiduciary duty claim, on the ground that any alleged breach was ratified by the fully-informed vote of the public shareholders.[182] The plaintiffs in turn argued

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ever, the Cullmans nonetheless held voting control due to their ownership of the Class B shares. *Id.* at *3 n.44.

175. *Id.* at *3.

176. *Id.*

177. *Id.*

178. *Id.* at *3 n.45.

179. *Id.* at *4.

180. *Id.*

181. *See* Orman v. Cullman, 794 A.2d 5 (Del. Ch. 2002).

182. *Orman*, 2004 WL 2348395 at *4.

that the shareholder vote was "coerced" by the existence of the voting agreement between the Cullmans and Swedish Match, and that the voting agreement effectively prevented any other transaction from taking place for eighteen months, which effectively forced the public shareholders either to choose the premium represented by the Swedish Match proposal or forego any other possible premium for a year and a half.[183]

The court wrote that while the voting agreement may have been purportedly "a deal protection measure for Swedish Match designed to prevent the Cullman Group and General Cigar from shopping Swedish Match's offer," it was possible that "the facts could be less benign."[184] As such, the Chancery Court denied the motion without prejudice so that the record could be further developed regarding the purpose of the voting agreement, and "how it came to be a term of the merger proposal."[185]

After discovery, the defendants renewed their motion for summary judgment. The plaintiffs countered that the voting agreement between the Cullmans and Swedish Match was impermissible under the language of *Omnicare*.[186] Plaintiff drew parallels to *Omnicare*, noting that the Swedish Match merger agreement included a similar force-the-vote provision, which required the deal to be placed before the shareholders even if the board withdrew its recommendation.[187]

Plaintiffs also alleged that the lock-up voting agreement effectively prevented an alternative transaction from taking place. They argued that these defensive measures combined to deprive public shareholders of any legitimate opportunity to obtain a better price for their shares, and coerced them into voting for the merger.[188] The plaintiffs further argued that merely entering into the voting agreement was a breach of the Cullmans' fiduciary duties as directors of the company, because it prevented any realistic chance of a third-party bidder coming forward.[189]

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183. *Id.*

184. *See* Orman v. Cullman, C.A. No. 18039, slip op. at 3 (Del. Ch. Aug. 16, 2002).

185. *Id.*

186. *Orman*, 2004 WL 2348395 at *5.

187. *Id.*

188. *Id.*

189. *Id.*

The Chancery Court rejected plaintiffs' arguments that the Cullmans breached their fiduciary duties by entering into the voting agreement. The court examined the record and found that the Cullmans entered into the voting agreement solely in their capacity as shareholders, and found nothing in the voting agreement that prevented the Cullmans from exercising their duties as officers and directors. The court held that the Cullmans had every legal right to vote or trade their shares as they saw fit, and the fact that they entered into a voting agreement was not a breach of any fiduciary duty.[190]

The court also distinguished *Omnicare*. Applying the *Unocal* standard, the court noted that if the Special Committee and full board had not approved the deal protection devices, they risked losing the Swedish Match offer. This was the same danger that the *Omnicare* court found sufficient to satisfy the first prong of *Unocal*. The court noted that during the negotiations, Swedish Match required some form of deal protection, and found that there was consideration offered to the shareholders for these defensive measures, namely an increase in the purchase price in exchange for an increased tail period. The court found that the first prong of the *Unocal* standard was satisfied.[191]

The court then analyzed whether the deal protection measures were "coercive" or "preclusive." In determining whether a measure is "coercive," the court looked to whether the measure had the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of the transaction. The court looked again to *Brazen*,[192] and held that although the existence of the provision might have influenced the shareholders in deciding whether to approve the deal, it could not be deemed unlawful coercion because without that provision there would have been no deal for the shareholders to consider in the first place.[193] The court ruled that "the 'lock-up' negotiated in this case is similar to the termination fee found permissible by the

190. *Id. See also* Bershad v. Curtiss-Wright Corp., 535 A.2d 840 (Del. 1987); Peter Schoenfeld Asset Mgmt. LLC v. Shaw, 2003 Del. Ch. LEXIS 79 (Del. Ch. July 10, 2003), *aff'd*, 2003 Del. LEXIS 624 (Del. Dec. 17, 2003).

191. *Id.* at *6 (quoting *Unocal*, 493 A.2d at 955).

192. Brazen v. Bell Atlantic Corp., 695 A.2d 43 (Del. 1997).

193. *Id.* at *7-8.

Supreme Court in Brazen [because] the deal would not have occurred without the inclusion of deal protection mechanisms."[194]

The court further observed that, unlike in *Omnicare*, the shareholder vote in *Orman* was not a "*fait accompli*."[195] First, General Cigar was permitted to withdraw its recommendation of the Swedish Match proposal if its fiduciary duties so required. Secondly, the requirement that a majority of the minority shareholders approve the merger preserved the board's ability to protect the public shareholders. Indeed, had the board of directors determined that it needed to recommend that General Cigar's shareholders reject the transaction, the shareholders were fully empowered to act upon that recommendation because the public shareholders—who were not locked-up in any way—retained the power to reject the proposed merger. Thus, unlike in *Omnicare*, the fiduciary out negotiated by General Cigar's board was "meaningful and effective."[196]

The court also examined whether the deal protection measures were within the range of "reasonable" responses to the risk of losing the Swedish Match transaction. The court found the evidence showing that there would have been no merger without the voting agreement rather convincing. If General Cigar's Board of Directors rejected the demanded deal protection measures, the shareholders could have lost the significant premium that Swedish Match's offer carried at a time when there was no competing offer. The court noted that this was "no small concern given the uncertain future of the tobacco business."[197]

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194. *Id.* The court also distinguished Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271 (Del. Ch. 1986), where a company's principal shareholder and CEO threatened to use his power to block transactions that might be in the company's best interest. However, unlike the termination fee in *Brazen* (and the voting agreement in *Orman*), the coercive actions taken in *Lacos Land* were not an intrinsic part of the proposal the shareholders were being asked to consider. *See id.* at *7.

195. *Id.* at *8.

196. *Id.*

197. *Id.*

V.
THE VARIOUS IMPLICATIONS OF THE *ORMAN* DECISION ON BOARDS OF DIRECTORS AND PUBLIC SHAREHOLDERS

The recent decision in *Orman* is a very significant development under corporate law, as it affects various elements of corporate governance. The ruling affects the decion making of boards of directors, and forces members of corporate boards to reconsider their actions in the light of new case law. As the first case by the Chancery Court to actually apply the controversial *Omnicare* decision, the case provides crucial guidance to corporate directors as to the legitimacy of various corporate defense mechanisms, including the ever popular lock-up provision. Specifically, *Orman* is a win for corporate directors, as the holding rejects efforts by the class action/shareholder derivative plaintiff bar to give *Omnicare* an extremely broad reach to circumstances beyond a "*fait accompli*" of the type presented in *Omnicare* itself.[198] The decision also answers another important question for directors of Delaware corporations. Faced with the question of whether a board must always retain for itself the power to terminate a merger agreement, *Orman* answers in the negative. Insead, the case stands for the proposition that it is sufficient for a board of directors to merely retain the ability to advise unaffiliated shareholders, and allow them to decide for themselves whether to approve or reject a proposed transaction.

The decision also establishes a basic framework for judging whether a lock-up agreement will be deemed enforceable by the Delaware courts. Although there are several dozen cases addressing the enforceability of lock-ups and break-up fees under Delaware law—most of which provide some guidance in determining what would constitute "too high" a break-up fee—Orman is unique in that no similar Delaware case law addresses the length of lock-up periods. While cases can always be distinguished under different facts, *Orman* provides at least some comfort that a lock-up period of eighteen months will not be deemed *per se* unreasonable.

Future plaintiffs will likely try to distinguish *Orman* on its facts, and may indeed, be successful. The facts of *Orman* presented the Chancery Court with unique circumstances and

198. *Id.* at *7-8.

factors which when considered all together, absolved the General Cigar Board of Directors from liability. It is still unclear which of these factors Delaware courts will highlifht in future cases examining corporate defense mechanisms.

Still, *Orman* provides much needed clarification about the definition of "coercion" under the *Omnicare* framework. The ruling makes clear that just because a deal protection device may influence a shareholder's decision, it does not necessarily constitute improper "coercion" and will not necessarily invalidate a deal.[199] Rather, the inquiry becomes whether the deal protection device causes shareholders to vote for reasons that are unrelated to the merits of the transaction. In *Orman*, the record showed that the voting agreement was an integral part of the transaction.[200] Therefore, the shareholders could not fairly be said to have been coerced by its inclusion in the proposal. Further, the court held that the shareholders were not coerced simply because the Cullmans had agreed to the lock-up and to vote against any alternative proposal for a period of eighteen months. In their capacity as shareholders, the Cullmans had the absolute right to vote their shares as they wished, no matter how beneficial another transaction might have been for the minority. By entering into the voting agreement, the Cullmans merely exercised that power in advance for a defined period. If a superior alternative proposal had emerged, the shareholders might have missed out on an offer with higher value. However, that outcome would have resulted from the fact that they simply did not have enough votes to push their agenda. *Orman* thus confirms that nothing in *Omnicare* limits the controlling shareholder's rights as an individual shareholder of the corporation.

To these ends—and many others—*Orman* is a very important decision in the realm of mergers and acquisitions law. It remains to be seen whether more decisions will follow suit and recognize that while deal protection measures may impose some burden on a company's shareholders, this is often the price a board must pay to act in those shareholders' best interest.

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199. *Id.* at *7.
200. *Id.* at *4-5.