CLIENT
MEMORANDUM

DELAWARE SUPREME COURT STRIKES DOWN ABSOLUTE LOCK-UP OF MERGER AS A PRECLUSIVE AND COERCIVE DEFENSIVE MEASURE

Introduction

On April 4, 2003, the Delaware Supreme Court -- in a 3-2 decision -- issued an important and controversial ruling addressing the obligations of a selling company's board of directors when it approves a merger agreement without a "fiduciary out" clause and approves voting agreements by the company's majority shareholders that "lock-up" the merger. *Omnicare, Inc. v. NCS Healthcare, Inc. et al.*, No. 605, 2002, 649, 2002, 2003 WL 1787943 (Del. Apr. 4, 2003)

Background

NCS Healthcare, Inc., an insolvent Delaware corporation ("NCS"), was the subject of competing acquisition bids, one by Genesis Health Ventures, Inc., a Pennsylvania corporation ("Genesis"), and the other by Omnicare, Inc., a Delaware corporation ("Omnicare"). In July 2002, after NCS had engaged in a lengthy and extensive process to find an acquiror, the board of directors of NCS agreed to the terms of a merger with Genesis. At the insistence of Genesis, the NCS-Genesis merger agreement contained a provision -- authorized by Section 251(c) of the Delaware General Corporation Law -- that required the merger agreement to be submitted to the NCS stockholders for a vote, even if the NCS board subsequently withdrew its recommendation of the transaction. In addition, Genesis insisted that the merger agreement not contain a "fiduciary out" clause permitting the NCS board to terminate the merger agreement, even if a superior proposal emerged after execution of the merger agreement. Genesis also insisted that two NCS stockholders (who were also NCS directors), holding over 65% of the voting power of NCS, enter into voting agreements unconditionally agreeing to vote in favor of the NCS-Genesis merger. Thus, the combined terms of the merger agreement and the voting agreements *guaranteed* that the transaction would garner NCS stockholder approval, even if a superior proposal later emerged.

By the time the NCS board had agreed to the terms required by Genesis, Omnicare had made various overtures to NCS that (i) were conditional on due diligence, (ii) would have required an asset sale in bankruptcy at a "fire sale price," and (iii) would have left no recovery for NCS stockholders. The NCS board -- and a committee of independent NCS directors -- concluded that the certainty of an executed merger agreement with Genesis (even containing the contractual provisions and coupled with the voting agreements required by Genesis) outweighed the benefits of a possible future transaction with Omnicare. However, after execution of the merger agreement and the voting agreements, Omnicare made a revised proposal that was substantially economically superior to the Genesis merger terms. The NCS board thereupon withdrew its recommendation that stockholders vote in favor of the Genesis transaction. Despite withdrawal

of the NCS board recommendation, the terms of the merger agreement and the voting agreements assured consummation of the economically inferior Genesis transaction.

Omnicare and the minority NCS stockholders commenced an action in the Delaware Chancery Court seeking to enjoin the Genesis transaction on the grounds that the NCS board had breached its fiduciary duties by agreeing to the terms of the merger and the voting agreements.

The Chancery Court's Decision

The Chancery Court (Vice-Chancellor Lamb), applying the business judgment rule, rejected the claim that the NCS board had not adequately explored alternative transactions, and found that the NCS board had discharged its duty of care in agreeing to the Genesis merger. The Chancery Court also ruled that the "deal protection devices," *i.e.*, the mandatory vote provision in the merger agreement and the voting agreements, constituted defensive measures within the meaning of the seminal Delaware case of *Unocal Corp. v. Mesa Petroleum, Inc.*[1] However, after applying the *Unocal* standard of enhanced judicial scrutiny, the Chancery Court held that the "deal protection devices" were reasonable defensive measures in relation to the threat posed -- that is, the threat that if the transaction with Genesis did not go through there was a possibility that there would be no transaction at all.

The Majority Decision in the Supreme Court

The Supreme Court, applying the same enhanced standard of judicial scrutiny imposed by *Unocal*, reversed the Chancery Court's ruling.[2] The Supreme Court held that the "deal protection devices," in the absence of an effective "fiduciary out" clause, were both "preclusive" and "coercive" and, therefore, were unenforceable.

Under the two-part *Unocal* analysis, the NCS board had the burden of demonstrating that (i) it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (ii) its defensive response was reasonable in relation to the threat posed. The Supreme Court found that the NCS board met its burden with respect to the first part of the test, but failed the second part.

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1 *Unocal Corp. v. Mesa Petroleum, Inc.,* 493 A.2d 946 (Del. 1985). *See also Unitrin, Inc. v. Am. Gen. Corp.,* 651 A.2d 1361 (Del. 1995).

2 The Court assumed, but did not decide, that the business judgment rule applied to the NCS board's decision to merge with Omnicare. The Court nevertheless noted that the NCS board had (i) abandoned a "stalking horse" strategy recommended by the independent committee to attract buyers, (ii) executed an exclusivity agreement with Genesis, (iii) agreed to a 24-hour ultimatum imposed by Genesis to make a final merger decision, and (iv) executed a merger agreement without reading it entirely, relying instead upon a summary of its terms.

The Court found that the "deal protection devices" were both "preclusive" and "coercive" because the combination of the mandatory vote provision in the merger agreement, the voting agreements, and the absence of an effective "fiduciary out" clause made it "mathematically impossible" and "realistically unattainable" for the Omnicare transaction or any other proposal to succeed, no matter how superior the proposal. In other words, the Genesis merger was a "*fait accompli.*"

The Court further held that, in addition to being preclusive and coercive, the defensive measures were unenforceable because they "completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction." The Court specifically criticized the NCS board for failing to negotiate an effective "fiduciary out" in the merger agreement:

> The directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced. Genesis anticipated the likelihood of a superior offer after its merger agreement was announced and demanded defensive measures from the NCS board that *completely* protected its transaction. Instead of agreeing to the absolute defense of the Genesis merger from a superior offer, however, the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer. By acceding to Genesis' ultimatum for complete protection *in futuro*, the NCS board disabled itself from exercising its own fiduciary obligations at a time when the board's own judgment is most important, i.e. receipt of a subsequent superior offer.

Omnicare, 2003 WL 1787943 at *20-21 (emphasis in original) (footnotes omitted).

The Dissents

In a rare occurrence in the Delaware Supreme Court, two justices strongly dissented. Chief Justice Veasey and Justice Steele each issued a dissenting opinion. Chief Justice Veasey, in his opinion in which Justice Steele joined, criticized the majority for reviewing the deal protection devices in a vacuum, noting that if the voting agreements had not been executed and the NCS board had not agreed to the mandatory vote provision in the merger agreement or had insisted on a "fiduciary out," the "only value-enhancing transaction available would have disappeared." Chief Justice Veasey acknowledged that there is value to the certainty provided by "lock-ups" and that any bright-line rule prohibiting "lock-ups" could chill otherwise permissible conduct, because scenarios will arise where "business realities demand a lock-up so that wealth-enhancing transactions may go forward." Although Chief Justice Veasey acknowledged that the minority stockholders obtained a better economic deal, he concluded that Delaware jurisprudence should

be seen as not turning on "such ex post felicitous results," but rather must subject board action to "a real-time review." Both Chief Justice Veasey and Justice Steele concluded that the board acted in good faith in agreeing to the merger agreement and approving the voting agreements.

Conclusion

After *Omnicare*, voting agreements with controlling shareholders that irrevocably and absolutely lock-up a transaction, in the absence of a meaningful "fiduciary out" provision, are suspect under Delaware law. Furthermore, deal protection devices that render "mathematically impossible" or "realistically unattainable" any subsequent proposal (whether or not on the horizon at the time the devices are entered into) that may offer superior terms to shareholders are susceptible to legal challenge.

There is no doubt that *Omnicare* has the potential to create uncertainty for bidders, sellers and controlling shareholders alike. Parties to corporate transactions, and their advisors, will need to remain creative to ensure that bidders are sufficiently incentivized to make bids and execute merger agreements; however, any deal protection provisions may need to allow directors some flexibility to consider developments that occur after a merger agreement has been executed. It is possible, as the dissent points out, that *Omnicare* will be limited to its facts. Indeed, the majority made it clear that it was *not* ruling on the "general validity of either stockholder voting agreements or the authority of directors to insert a Section 251(c) provision in a merger agreement." Rather, it was the combination of those "two otherwise valid actions" and causing them to "operate in concert as an absolute lock up in the absence of an effective fiduciary out clause" that made the provisions pernicious.

This is an evolving area of the law and we recommend that clients having questions about deal protection provisions generally, or the *Omnicare* decision specifically, should call the corporate partner with whom they regularly work.

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Willkie Farr & Gallagher is headquartered at 787 Seventh Avenue, New York, New York 10019. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111.

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