

COMPLEX LITIGATION



A SPECIAL REPORT

M&A on the rise — and litigation may well follow

Techniques for minimizing the power of skeptical shareholders may land deals in court.

BY MICHAEL W. STOCKER
AND CHRISTINE S. AZAR

This is proving to be a blockbuster year for mergers and acquisitions. After a long period of stagnation during the financial crisis and its immediate aftermath, ample money — and appetite — now exists for deals to be struck by private-equity firms looking to buy into the upswing in the markets, as well as for corporations seeking to make strategic acquisitions. However, recent developments in Delaware law and innovations in the way these transactions are structured foretell an equally lively year for shareholder litigation.

Conditions are certainly right for the strong uptick in deals seen in 2010 to continue, and even accelerate. Interest rates are low and companies have been hoarding cash, so the ability to buy is strong. Perhaps more importantly, shares in many

companies remain undervalued from an historical perspective, as many corporations still suffer from the hangover of our recent recession. This combination of buying power on the acquisition side and temporary depression in prices makes for an unusually risky climate for investors seeking to evaluate a takeover offer.

Recent trends in deal structures reflect an increase in provisions that seem designed to minimize the power of skeptical shareholders in target companies to put the brakes on acquisitions. Some of these provisions, such as poison pills, are familiar features being used in new ways, while others, such as “top-ups,” are more recent innovations still subject to considerable controversy. A review of recent cases involving each of these devices is instructive in seeing how far the courts are willing to go in scrutinizing deal terms that weaken or eliminate shareholder votes.

A shareholder rights plan, or “poison pill,” can be adopted by a board in response to a perceived takeover threat. The pill grants shareholders the right to buy more shares at a discount if one shareholder (who does not have such a right) buys a certain percentage of the company’s shares. Such purchases will dilute the bidder’s interest, and the cost of the bid will rise substantially, squelching the offer. Effectively, poison pills give boards the power to refuse to put an offer to shareholders — even if shareholders might want to consider the proposal.

The Delaware Supreme Court first upheld the use of a poison pill as a valid takeover defense more than 25 years ago in *Moran v. Household International Inc.*, 490 A.2d 1059 (Del. 1985). However, the use of these devices is still far from settled.

The most famous recent case stems from the attempted acquisition by Air Products and Chemicals Inc. of Airgas Inc. The case turned

on whether the board of Airgas could refuse to put an unsolicited, noncoercive, all-cash tender offer to shareholders, to maintain the status quo. In the end, Chancellor William B. Chandler III upheld the board's ability to use the poison pill to prevent shareholders from accepting a \$5.9 billion bid by Air Products, which the board believed was financially inadequate. See *In re Airgas Inc. Shareholder Litig.*, C.A. No. 5256-CC (Del. Ch. Feb. 15, 2011). In doing so, the court reaffirmed the great deference given to a board in making the initial determination of whether the company faces a threat — and substantially weakened the ability of shareholders to consider offers they might think in their best financial interest.

A relatively new but increasingly prevalent provision seen in recent tender offers is the “top-up” option, whereby an acquirer, after receiving a minimum amount of the target company's shares in the tender offer (usually 50%), is entitled to buy a sufficient number of the target company's authorized and unissued shares at the tender price to reach the 90% threshold that allows it to then complete a second step “short form” merger under Del. Code tit. 8, § 253. All this takes place without the need for any shareholder vote at all.

Supporters of the top-up option argue that it is designed to get the merger consideration into the hands of shareholders more quickly. Challenges to top-ups generally have been on the grounds that the exercise of the top-up diluted the company's value in the appraisal context and that the promissory note given as consideration for the top-up shares renders the transaction illusory, since the acquirer is likely to cancel the note once the acquisition is complete.

So far, these objections have gotten a frosty reception from the

Delaware Court of Chancery. See *In re ICX Technologies Inc.*, C.A. No. 5769-VCL (Del. Ch. Sept. 10, 2010) (finding that the merger agreement expressly excluded the top-up shares from any appraisal calculation); *In re Cogent Inc. Shareholder Litig.*, 7 A.3d 487 (Del. Ch. 2010) (upholding top-up because parties had excluded top-up shares from appraisal and the promissory note was a legally enforceable obligation at the time it was issued); and *In re Protection One Inc.*, C.A. No. 5468-VCS (Del. Ch. Oct. 6, 2010) (expressing view that by operation of law, top-up shares would not be included in the appraisal context). These decisions mean, at least for now, that top-up arrangements can result in public shareholders being completely cashed out of an investment with no say other than appraisal rights, a long and expensive process in Delaware. Future challenges to top-ups as a deal-protection device are likely.

CONTINGENT VALUE RIGHTS

An interesting twist on the negotiation of price in acquisitions of target companies in Delaware and elsewhere is the re-emergence of the use of contingent value rights (CVR). A CVR is a contractual right to potentially receive future consideration after a merger based on performance benchmarks or the outcome of other identifiable contingencies. It is used most often in the context of startup biotech and pharmaceutical companies when the value of the company is largely tied to the success of a particular product or technology. The issues for shareholders voting on a proposed merger are determining what a CVR is actually worth in assessing whether the merger consideration is adequate, and deciding whether to vote for or against the merger — or to pursue appraisal rights instead.

Shareholders challenging these

provisions will likely assert that a CVR is worth zero, as it is nothing more than a contingent right to potentially receive some additional value in the future. Even if something is ultimately paid in accordance with a CVR, the time value of money necessarily means it is worth less than if the same consideration were received as part of the original merger. Defenders of CVR, on the other hand, argue that it allows shareholders being cashed out in a merger to still participate in any future upside, particularly when the target company is in a growing or expanding field.

The battles over poison pills, top-ups and offer valuations only highlight the pervasive wariness between shareholders and boards that followed the financial crisis of 2007-08. If there is one lesson that many investors took away from the events of those two years, it is that shareholder and board interests are not always perfectly aligned — and these divisions will continue to play out this year with the surge in mergers and acquisitions activity.

Michael W. Stocker is a partner at Labaton Sucharow who represents institutional investors in shareholder litigation. Christine S. Azar is a partner in the firm's Delaware office. She is a seasoned litigator in matters concerning investor rights and has prosecuted complex corporate and securities litigations in Delaware and throughout the United States.