Corporate and Securities Law Update

M&A Development: Omnicare—Court Declares Certain Deal Protection Mechanisms Unenforceable

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Introduction

Since the *Ace* case was decided by the Delaware Court of Chancery, M&A practitioners have assumed (and argued when representing targets) that having a deal "too locked up" with voting agreements and other deal protections may be a breach of fiduciary duty, except possibly in circumstances where the premium was significant and the amount of pre-deal "shopping" was extensive. The general assumption was that there had to be a path for a new bid to be effectively made and the stockholders had to be given an effective opportunity to vote on any superior bid.

Nevertheless, buyers occasionally push deal protection to the point that a deal is fully locked up, on the theory that it is better to put off other potential bidders and possibly litigate later about the enforceability of deal protections, than to leave an effective "fiduciary out" that might allow another bidder to succeed. Boards, particularly those whose companies are facing financial difficulties, may feel they are left with no option but to accept such fully locked deals.

Executive Summary

In *Omnicare, Inc. v. NCS Healthcare, Inc.*, Nos. 605, 2002 and 649, 2002, Holland, J. (Del. April 4, 2003), the Supreme Court of Delaware, by a 3 to 2 vote, effectively warns M&A deal makers that overreaching deal protection mechanisms (here consisting of voting agreements covering a majority of shares coupled with a provision compelling a stockholder vote) may be unenforceable in the event that a superior bid emerges. The Court also warns boards that entering into a fully locked deal without an effective "fiduciary out" may be an abdication of the board's responsibility to retain the ability to exercise its fiduciary duties in that context. The text of the complete decision may be found online at: http://courts.state.de.us/supreme/ordsops/605-2002a.pdf.

Facts

In *Omnicare*, NCS was in a situation faced by many troubled companies. NCS had a depressed stock price and was in default on $350 million of debt. NCS contacted over fifty potential buyers and engaged in negotiations with two bidders, Genesis and Omnicare, who were competitors. Omnicare had previously submitted a successful, 11th hour competing bid for an unrelated company that Genesis had sought to acquire, so Genesis was determined not to allow Omnicare to outbid it in this potential acquisition for NCS. NCS played on this rivalry and used the threat of an Omnicare bid to substantially improve the Genesis bid to the extent of paying off all debt and producing a return for stockholders. However, Genesis insisted on a fully locked deal, which was troublesome to the NCS board, since Omnicare gave indications of a willingness to substantially improve its prior conditional offers.

Genesis required that (i) two NCS directors who controlled 65% of the voting power agree to irrevocable voting agreements, (ii) NCS agree to take the Genesis merger proposal to a stockholder vote even if a superior bid was made and even if the NCS board changed its recommendation in favor of the Genesis merger (a so-called "force the vote" provision), and (iii) the NCS board not reserve an effective "fiduciary out" (*i.e.*, a right to terminate the Genesis deal without breach if, in light of a superior bid, it determined that its fiduciary duties so required).

Given the rivalry between Omnicare and Genesis, and Genesis' indications that it refused to be a "stalking horse" to enable NCS to obtain a better bid from Omnicare, the NCS board took seriously Genesis' ultimatum that NCS agree to this preclusive lock up or Genesis would terminate negotiations. The NCS Board agreed to Genesis' demands and signed the merger agreement with Genesis. Thereafter, Omnicare mounted a tender offer for NCS that was clearly a superior offer. The NCS board eventually changed its recommendation and NCS' investment banker withdrew its fairness opinion relative to the Genesis merger.

Omnicare and a shareholder class sued to prevent enforcement of the deal protection mechanisms. The Supreme Court reversed the Court of Chancery (which had ruled that the NCS Board's approval of a fully locked-up transaction without a "fiduciary out" was reasonable under the circumstances) and enjoined

enforcement of the voting agreements so as to allow the superior Omnicare deal to proceed.

Analysis and Holding

Reviewing these facts, the majority in Omnicare held and reasoned as follows:

- When a deal is fully locked up (*i.e.*, it is "mathematically impossible" or "realistically unattainable" for another bidder to succeed), making closing a fait accompli, through a combination of deal protection devices, here consisting of (1) specifically enforceable voting agreements committing stockholders with a majority of the voting power to vote for the deal, (2) a "force the vote" provision, and (3) the absence of an effective "fiduciary out", so as to prevent the board from being able to effectively exercise its fiduciary duties, then such deal protection devices are unenforceable.

- The deal protection devices required by Genesis were unenforceable not only because they are preclusive of other deals and coerce stockholders to accept a management-supported transaction, but also because they completely prevented the board from effectively discharging its fiduciary duties. To the extent that merger protection devices purport to require a board to act or not act in such a fashion as to limit the exercise of its fiduciary duties, they are invalid and unenforceable.

- Even though NCS was in default on its debt, the NCS board did not have authority to accede to Genesis' demand for an absolute "lock-up" that would prevent it from later effectively discharging its ongoing fiduciary responsibilities. Instead, it was required to negotiate and contract for an effective fiduciary out clause that would enable it to exercise its continuing fiduciary responsibilities. By completely locking the deal, the NCS board disabled itself from being able to exercise its fiduciary obligations upon receipt of a superior offer, when the board's judgment is deemed most important. Such board action was an abdication of its fiduciary duties, since it prevented the board from protecting minority holders' interests, which was particularly critical here given that the majority holders had already agreed to vote for the deal.

- The directors' decision to adopt defensive devices that collectively fully locked up the Genesis merger mandated "special scrutiny" under *Unocal*, even if the merger would not result in a "change of control" within the meaning of Delaware case law. If deal protection devices, considered collectively, have the effect of being preclusive or coercive, they are unenforceable, so there is no need to evaluate them further under the "range of reasonableness" *Unocal* standard (which requires that defensive devices be proportional to the perceived threat of not consummating the deal).

Lessons

Omnicare gives a few lessons for M&A deal makers:

- Buyers should avoid overly aggressive negotiating tactics. Here, the Court seemed influenced by Genesis' threat to terminate discussions unless NCS accepted a fully locked deal within 24 hours.

- Parties should more carefully evaluate whether mechanisms intended to protect a deal might be voided as preclusive, leaving the deal more at risk.

- Target boards should resist agreeing to a fully locked deal given the finding here of abdication of fiduciary duty despite a clear record of informed, disinterested, good faith NCS board action that the vigorous and cogent *Omnicare* dissent found to be reasonable. Buyers may argue that *Omnicare* is limited to its facts.

- Parties are well advised to either avoid voting agreements that bind a majority of the voting power (at least when coupled with a "force the vote" provision) or include an effective "fiduciary out." (Note, however, that parties are still free to use voting agreements and "force the vote" provisions, so long as their use in combination does not result in a fully locked deal. The Court acknowledged that "force the vote" provisions were expressly authorized by Delaware law (so long as they are implemented consistently with directors' fiduciary duties) and that the Court had previously held that voting agreements were not always subject to *Unocal* review.)

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