M&A Panel Discussion: Initial Negotiation and Documentation

United States

Zachary S. Podolsky
Wachtell, Lipton, Rosen & Katz

Preliminary Considerations in the M&A Deal-Making Process

A. Preliminary Agreements: Confidentiality Agreements and Letters of Intent

Companies considering M&A transactions should be cognizant of certain risks arising from negotiations that take place and agreements that are entered into before the execution of definitive transaction agreements. Preliminary agreements, such as confidentiality agreements and letters of intent, are sometimes seen as routine or relatively inconsequential. Because of this, parties sometimes enter into these agreements without sufficient consideration of their provisions, sometimes without involving counsel at all, only to later find themselves restricted or obligated in ways they had not anticipated. It is important to appreciate that the merger process begins with (or even before) the first discussions and that each step in the process may have significant consequences.

1. Confidentiality Agreements

Often, the first legally binding undertaking in an M&A transaction negotiation is the execution of a "confidentiality agreement," which is sometimes referred to as a "Non-Disclosure Agreement" or "NDA." It is entirely understandable that a company providing its proprietary or non-public information to another company would want to protect its confidentiality and ensure that it is only used for its intended purpose. However, this seemingly innocuous document often includes important substantive agreements. For example, a confidentiality agreement will often contain an express "standstill" provision restricting the ability of the party (or parties, if it is mutual) receiving information from taking various actions with respect to the other party, including commencing a takeover bid, buying shares, participating in proxy contests and engaging in other acts considered "unfriendly" to the party providing the information. This standstill agreement will continue for a set period or until a specified "fall-away" event, such as the announcement of a transaction with a third party.

When standstill provisions are included in confidentiality agreements, they are typically worded very tightly to prevent a party that has obtained confidential information about a company from making an unsolicited bid or otherwise taking harmful action against the disclosing party. To prevent evasion of the standstill, these provisions typically specify that the bound party may not even request a waiver, to avoid putting the disclosing company "in play." Delaware courts have in recent years focused on these provisions, which they call "Don't Ask, Don't Waive" clauses, to ensure that they do not unduly restrict a board of directors from complying with its *Revlon* duties to maximize shareholder value once a decision is made to sell the company. The courts have recognized, however, that a "Don't Ask, Don't Waive" provision may sometimes be appropriate. For example, when conducting an auction to sell the company, the board may decide to include a "Don't Ask, Don't Waive" provision to incentivize bidders to put their best foot forward in the auction rather than holding back, knowing they can overbid the auction winner later. Because of the effect such a provision may have, the Delaware courts have indicated that they would expect a board to include it only after careful consideration of its impact.

Even in the absence of an explicit standstill provision, a confidentiality agreement may give rise to claims that the agreement prohibits the parties from taking certain actions, including unsolicited bids. In addition to requiring that information provided be kept confidential, confidentiality agreements typically restrict the use of the information provided for the purpose of evaluating and negotiating a transaction (sometimes a specifically contemplated transaction) between the parties. Until a few years ago, Delaware courts had not considered whether a violation of disclosure and use restrictions would be a basis for blocking a takeover bid. The Delaware Court of Chancery's 2012 decision in *Martin Marietta Materials, Inc.* v. *Vulcan Materials Co.*,[i] which subsequently was affirmed by the Delaware Supreme Court, determined that Martin Marietta breached both the use and disclosure restrictions in two confidentiality agreements. Although then-Chancellor Strine found the wording to be ambiguous (but more consistent with Vulcan's reading), after an exhaustive interpretive analysis of the language of the agreements and parsing of whether a business combination "between" the parties would include a hostile takeover and proxy contest, he concluded that the parties—especially Martin Marietta—intended the agreement to preclude use of the information exchanged in a hostile transaction. He also held that Martin Marietta had willfully breached its non-disclosure commitments by disclosing details of the parties' confidential negotiations in tender and other materials, without complying with the required procedures under the agreements. Consequently, the Court enjoined Martin Marietta's unsolicited takeover bid for four months, which effectively ended its hostile bid.

More recently, a California court in *Depomed Inc.* v. *Horizon Pharma, PLC*[ii] preliminarily enjoined a hostile bidder on the ground that it misused information in violation of a confidentiality agreement, effectively ending the hostile takeover attempt. Unlike in *Vulcan*, the confidentiality agreement at issue was not signed directly between acquiror and target. In 2013, Horizon, while pursuing a co-promotion arrangement concerning a particular drug asset owned by Janssen Pharmaceuticals, Inc. ("Janssen"), signed a confidentiality agreement with Janssen containing customary provisions limiting Horizon's permitted use of Janssen proprietary information solely to evaluating Horizon's interest in pursuing a business relationship with Janssen. Without signing a new confidentiality agreement, Horizon later participated in an auction process that Janssen ran for the drug asset. Depomed also participated, winning the auction and acquiring the U.S. rights to the drug asset. Two years later, Horizon launched a hostile bid for Depomed, which sued for injunctive relief, asserting that Horizon was improperly using information relating to the drug asset in evaluating and prosecuting its hostile bid. In a ruling applying the plain terms of the agreement, the court rejected arguments that the confidentiality agreement only applied to the earlier co-promotion transaction structure. The court concluded that it was likely that Depomed had acquired the right to enforce the confidentiality restrictions against Horizon, noting that "a different conclusion would be illogical as it would mean that Depomed could not protect the confidential information" about its newly acquired asset.[iii] The court held that Horizon had misused confidential information in formulating its takeover proposal, and Horizon withdrew its bid the following day.

Since *Vulcan*, parties have generally focused more closely on making clear the extent, if any, to which the confidentiality agreement should be interpreted to prevent a hostile bid by one of the parties. *Depomed* is a further reminder that parties should generally beware of the obligations contained in confidentiality agreements, especially where the possibility of assigning such agreements can transform the nature of the original obligation and cause unanticipated limitations on future strategic opportunities. Such agreements should be carefully reviewed by counsel before execution.

Other typical provisions in confidentiality agreements may also have far-reaching consequences for the parties to a potential transaction. For example, a party providing confidential information often insists that the confidentiality agreement contain broad disclaimer and non-reliance language making clear that the providing party has not made any representation or warranty to the receiving party as to the accuracy or completeness of the information provided, and that the providing party will not have any liability to the receiving party arising from the use of the information. Delaware courts have enforced broad disclaimer and non-reliance language that effectively allocates to the potential buyer the risk that information provided by the potential seller may be inaccurate until a definitive transaction agreement is signed, even in the case of allegations of fraud.[iv] Other important provisions to focus on include restrictions on solicitation of employees, limits on disclosure of the transaction process and details (even if required by law), application of the confidentiality agreement to the parties' advisors, and the termination provisions.

2. Letters of Intent

Another common preliminary agreement is the letter of intent, sometimes referred to as a "memorandum of understanding" or "MOU." Letters of intent are more common in private transactions than in public company deals, although it is not uncommon even in public deals for parties to negotiate term sheets, which are similar in that they spell out the most critical terms of a proposed transaction but are typically unsigned.

Whether to negotiate a letter of intent or proceed straight to definitive documentation is dependent upon the facts in each case. Letters of intent can serve several purposes at the outset of negotiations, including demonstrating both parties' commitment to the possible transaction, allocating responsibility for certain documents, establishing a time frame for executing definitive agreements, creating a period of exclusivity of negotiations, allocating responsibility for expenses, and serving as a form of preliminary documentation for third parties requesting it (such as lenders). A letter of intent can also be used to make a Hart-Scott-Rodino antitrust filing, so as to commence the requisite waiting period, even if the letter of intent is not binding. While letters of intent can be useful to identify any deal-breakers early on in negotiations, saving the parties from unfruitful expenditure of time and money, they can also take time to negotiate (leading to the possibility of leaks), may impact the dynamics between the parties, and can raise disclosure issues in the case of public companies.

Even when executed by the parties, most provisions of a letter of intent are non-binding agreements to agree, although some provisions are expressly intended to be binding (for example, the grant of an exclusivity period or an expense reimbursement provision). It is essential that the parties are clear as to whether, and to what extent, a letter of intent is intended to be binding and enforceable.[v] Because they are cursory in nature, letters of intent typically state that the document is meant to be non-binding in nature and that the parties will only be bound upon execution of definitive agreements. The absence of such language could lead a court to hold the letter of intent enforceable. For example, the Delaware Court of Chancery ruled in a 2009 bench decision on a motion for a temporary restraining order that a jilted bidder had asserted colorable claims that a target had breached the no-shop/exclusivity and confidentiality provisions of a letter of intent, as well as its obligation to negotiate in good faith.[vi] In reaching its decision, the Court stated that parties that wish to enter into nonbinding letters of intent can "readily do that by expressly saying that the letter of intent is nonbinding," and that contracts "do not have inherent fiduciary outs"—points that practitioners representing sellers should keep in mind from the outset of a sale process.

Even where express language that a letter of intent is non-binding is present, there may be other facts and circumstances that could lead a court to determine that the parties intended the letter of intent to be binding. In *SIGA Technologies, Inc.* v. *PharmAthene, Inc.*, SIGA and PharmAthene negotiated a licensing agreement term sheet (the "LATS") that was unsigned and had a footer on both pages stating "Non-Binding Terms."[vii] The LATS was later attached by the parties to a merger agreement and a loan agreement, both of which provided that if the merger agreement was terminated, the parties would nevertheless negotiate a licensing agreement in good faith in accordance with the terms of the LATS. After terminating the merger agreement, SIGA claimed that the LATS was nonbinding and attempted to negotiate a licensing agreement with economic terms "drastically different and significantly more favorable to SIGA"[viii] from those in the LATS. The Delaware Supreme Court affirmed the Court of Chancery's finding that the parties intended to negotiate a license agreement on economic terms substantially similar to those in the LATS and that SIGA's failure to so negotiate was in bad faith. The Court ruled that the LATS was not a mere "jumping off point," but rather the parties had agreed to an enforceable commitment to negotiate in good faith.[ix]

By contrast with the result in *SIGA*, the Delaware Supreme Court held in *Ev3, Inc.* v. *Lesh* in 2014 that a nonbinding provision of a letter of intent does not become binding solely because the merger agreement contains an integration clause providing that the letter of intent is not superseded.[x] The parties in *Ev3* had negotiated a nonbinding letter of intent that included a "Funding Provision" under which the acquiror committed to providing capital to help the target achieve certain development milestones, which were conditions to the payment of the merger consideration. Though the integration clause of the merger agreement provided that the letter of intent was not superseded, the merger agreement also provided that the acquiror could fund and pursue the milestones in its "sole discretion, to be exercised in good faith," and that such provision would override any other provision in the merger agreement to the contrary.[xi] The Delaware Supreme Court concluded that "[s]urvival is not transformational,"[xii] and that the integration clause did not convert the non-binding Funding Provision into a binding contractual obligation; rather the reference to the letter of intent in the integration clause was to make sure that the binding provisions of the letter of intent were not extinguished by the merger agreement. The Court concluded that the selling stockholders were not entitled to rely on the Funding Provision in the letter of intent in arguing that the acquiror had failed to perform its contractual duties.[xiii]

Parties that do not wish to be bound by provisions of a letter of intent should avoid statements or actions that may indicate that a letter of intent was understood by the parties to be binding. If maximum flexibility is desired, parties should also consider expressly disclaiming an obligation to negotiate in good faith and making clear that negotiations may be terminated without liability at any time until a definitive agreement has been executed.

Bid procedure letters sent on behalf of a selling company to potential bidders in an auction context can serve some of the functions of a letter of intent, and should similarly include language making absolutely clear that the target company has no legal, fiduciary or other duty to any bidder with respect to the manner in which it conducts the auction. Bid procedure letters should also include an express disclaimer to the effect that the bidder is not relying on any express or implied representation concerning the manner in which the auction will be conducted.

B. Choice of Sale Process: Auctions and Market Checks

A merger transaction may impose special obligations on a board. Every transaction is different, and courts have recognized that a board should have significant latitude in designing and executing a merger process. As the Delaware Supreme Court has several times reiterated, there is "no single blueprint" that directors must follow in selling a company.[xiv] This is true even if *Revlon* applies: directors are not guarantors that the best price has been obtained, and Delaware case law makes clear that "[n]o court can tell directors exactly how to accomplish that goal [of getting the best price in a sale], because they will be facing a unique combination of circumstances, many of which will be outside their control."[xv] Thus, *Revlon* "does not . . . require every board to follow a judicially prescribed checklist of sales activities."[xvi] Rather, the board has reasonable latitude in determining the method of sale most likely to produce the highest value for the shareholders. As a result, even in a change-of-control setting, a board may determine to enter into a merger agreement after an arm's-length negotiation with a single bidder, as opposed to putting the company up for auction or conducting a market canvass, if it determines in good faith that a single-bidder strategy is the most desirable. Even after a competitive bidding process has begun, a board may, under proper circumstances, favor one bidder over another "if in good faith and advisedly it believes shareholder interests would be thereby advanced."[xvii] In demonstrating that it pursued the best price reasonably available, it is generally necessary for the board to be able to point to some form of "market check," whether active or passive.

1. Formal Auction

In a "formal" auction, prospective acquirors are asked to make a bid for a company by a fixed deadline, in one or several "rounds" of bidding. A company, usually with the assistance of an investment banker, may prepare a descriptive memorandum, known as a "confidential information memorandum" or an "offering memorandum" (or just a short "teaser" since, in a public company sale, the material information is already public) that is circulated to prospective bidders. Prior to the bidding deadline, a company will typically send a draft contract and related documentation, along with a bid letter setting forth the auction process, to multiple parties. Interested bidders are allowed to engage in due diligence (subject to entering into a confidentiality agreement) and then submit their bids, together with any comments on the draft contract. A formal auction often has more than one round and sometimes involves simultaneous negotiations with more than one bidder.

A significant advantage of a formal auction is that it can be effective even if there is only one bidder. Absent leaks, a bidder has no way of being certain whether there are other bidders, and this creates an incentive to put forward its best bid. In addition, the seller in a formal auction can negotiate with bidders to try to elicit higher bids. A formal auction may be conducted openly (typically by announcing that the company has hired an investment bank to "explore strategic alternatives") or conducted without an announcement. Even without an announcement, however, it is difficult to conduct a formal auction without rumors of a sale leaking into the marketplace.

Companies may also engage in a limited or "mini-auction," in which only the most likely bidders are invited to participate. One difficulty in any auction process is that the true "value" of a bid, which must take into account not only the price to be paid but also the likelihood and timing of consummation and the related financing and regulatory approval risks, may be difficult to discern with certainty. Additionally, some bidders may propose stock or part-stock deals, which implicate considerations regarding valuation and pricing mechanisms. The optimal sale process to be employed depends on the dynamics of the particular situation and should be developed in close consultation with financial and legal advisors.

2. Market Check

An alternative to the auction technique is a "market check," whereby the seller gauges other potential buyers' interest without conducting a formal bidding process. A market check may be preferable to an auction for a number of reasons, including a reduced likelihood of leaks and a shortened negotiating timeframe. A seller may also forgo an auction because it determines that an auction is unlikely to yield other serious bids or because the seller strategically accedes to an attractive bidder's refusal to participate in an auction. It is important to note that a seller may appropriately conclude, depending on the circumstances, that it should negotiate only with a single bidder, without reaching out to other potential bidders pre-signing. A market check may occur either before or after the signing of a merger agreement, and may be active or passive.

a. Pre-Signing Market Check

In a pre-signing market check, a company, usually through its financial advisors, attempts to determine which parties may be interested in acquiring the company at the best price prior to signing an agreement without initiating a formal auction. A pre-signing market check may effectively occur even if not initiated by the company, for example, when there are public rumors that the company is seeking an acquiror or is the subject of an acquisition proposal (referred to as being "in play").

b. Post-Signing Market Check

In a post-signing market check, provisions in the merger agreement provide an opportunity for other bidders to make competing offers after execution of the agreement.[xviii] An advantage of a post-signing market check is that it ensures that the seller may secure the offer put forth by the first bidder while leaving the seller open to considering higher offers. Acquirors, of course, will typically seek to limit the post-signing market check and will negotiate for so-called "deal protections" such as a "no-shop" covenant, which restricts the seller's ability to solicit or discuss alternative transactions, and termination or "break-up" fees, in the event that the initial transaction is not consummated due to the emergence of a superior proposal. Another customary and powerful "deal protection" provision is a matching right, which allows the initial bidder an opportunity to match any higher bid that may be made. For a post-signing market check to be effective, potential bidders must be aware of the opportunity to bid, have sufficient information and time to make a bid, and not be unduly deterred by unreasonable break-up fees or deal protections afforded to the first bidder.

Post-signing market checks may either be active or passive. In an active market check, the merger agreement permits the seller to actively seek out new bidders—through a so-called "go-shop" provision discussed further below. In a passive market check, the merger agreement includes a "no-shop" provision prohibiting the active solicitation of alternative bids, but also includes a "fiduciary out" permitting the target board to consider higher bids that may emerge unsolicited. Because of the "no-shop" provision and the "fiduciary out," new bidders must take the first step of declaring their interest after hearing about the transaction. This is sometimes referred to as a "window shop" form of market check.

A board may discharge its fiduciary duties by selling a company through a single-bidder negotiation coupled with a post-signing, passive market check, even in a *Revlon* transaction. Although this method is more likely to be closely scrutinized by courts, it is permissible so long as the board is informed of the downsides of this approach and has an appropriate basis for concluding that they are outweighed by the benefits, and the transaction provides sufficient opportunity for competing bids to emerge. In 2011, Vice Chancellor Parsons ruled in *In re Smurfit-Stone* that an active market check was unnecessary because the selling company had been "in play" both during and after its bankruptcy, yet no competing offers were made.[xix] Similarly, in the *Fort Howard* case in 1988, which was reaffirmed by the Delaware Supreme Court in *C&J Energy Servs., Inc.* v. *City of Miami Gen. Emps.' Ret. Trust* in 2014, Chancellor Allen ruled that the company's directors had satisfied their fiduciary duties in selling the company by negotiating for an approximately month-and-a-half-long period between the announcement of the transaction and the closing of the tender offer in which new bidders could express their interest.[xx] The Chancellor ruled that the market check was not "hobbled" by deal protection measures and noted that he was "particularly impressed with the announcement [of the transaction] in the financial press and with the rapid and full-hearted response to the eight inquiries received."[xxi]

The Delaware Court of Chancery has provided valuable guidance for sellers considering forgoing an active market check. In *In re Plains*, Vice Chancellor Noble found that the directors were experienced in the industry and had "retained 'significant flexibility to deal with any later-emerging bidder and ensured that the market would have a healthy period of time to digest the proposed transaction.'"[xxii] When no competing bids surfaced in the five months after the merger was announced, the Plains board could feel confident it had obtained the highest available price. In contrast with *Plains*, in *Koehler* v. *NetSpend*, Vice Chancellor Glasscock criticized the NetSpend board's failure to perform a market check, given the other facts surrounding the merger.[xxiii] NetSpend's suitor entered into voting agreements for 40% of the voting stock and bargained for customary deal protections in the merger agreement, including a no-shop, a 3.9% termination fee and matching rights. The merger agreement also prohibited the NetSpend board from waiving "don't ask, don't waive" standstills that NetSpend had entered into with two private equity firms that had previously expressed an interest in investing in the company, but had not been part of a pre-signing auction or market check. Even though the record showed that the investment bank advising NetSpend's board had advised that a private equity bidder was unlikely to match the buyer's offer, Vice Chancellor Glasscock found that, by agreeing to enforce the "don't ask, don't waive" standstills, the NetSpend board had "blinded itself" to the two most likely sources of competing bids and, moreover, had done so without fully understanding the import of the standstills.[xxiv] This, combined with reliance on a "weak" fairness opinion and an anticipated short period before consummation, led Vice Chancellor Glasscock to conclude that the sales process was unreasonable.[xxv] *Plains* and *NetSpend* reinforce that the terms of a merger agreement and its surrounding circumstances will be viewed collectively, and, in the *Revlon* context, the sales process must be reasonably designed to obtain the highest price.

c. Go-Shops

Delaware courts have generally found "go-shop" provisions to be a reasonable, but not mandatory, approach to satisfying *Revlon* duties.[xxvi] Go-shop provisions offer buyers (often financial buyers) the benefit of avoiding an auction and the assurance of a break-up fee if a deal is topped (which is usually an acceptable outcome for financial buyers). On the other hand, a go-shop enables a company being sold (for example, to a private equity firm) to "lock-in" an acceptable transaction without the risks of a public auction, while mitigating the potentially heightened fiduciary concerns that can arise in such deal settings. These provisions allow the target to solicit competing offers for a limited time period (typically 30 to 60 days) after signing an acquisition agreement—permitting the target during that interval to, in the words of then-Vice Chancellor Strine, "shop like Paris Hilton."[xxvii] Go-shop provisions often provide for a lower break-up fee (most often half the fee that would apply after the go-shop period) if the agreement is terminated to accept a superior proposal received during the go-shop period.

Corporate acquirors do not necessarily welcome go-shops not only because they have heightened sensitivity to encouraging competitors to become interlopers, but because their interest in the target is strategic, meaning that receiving a break-up fee is usually a suboptimal outcome. However, strategic deals have also seen some tailored variations on go-shop provisions, like the "qualified pre-existing bidder" provision that U.S. pork processor Smithfield and Chinese meat processor Shuanghui employed in their 2013 combination. The agreement for that transaction carved out two pre-existing bidders from the no-shop provision and provided for a reduced break-up fee ($75 million, versus $175 million in other scenarios) for 30 days following execution of the agreement with respect to deals pursued with these bidders. Along these lines, an alternative approach to the standard go-shop that some strategic deals have taken has been to more broadly couple a no-shop with a lower break-up fee for a specified period of time (for example, the Pfizer/Wyeth deal).

When a go-shop provision is employed to satisfy the board's fiduciary duty, it is important that there be an active and widespread solicitation. Requisite information is made available to competing bidders who emerge, even though they may be competitors and the buyer and management may not want to provide sensitive information to them. In rare cases, where the seller's investment bank may have an incentive to support the transaction with the original buyer because of relationships or because they are providing financing for the transaction (which can raise its own conflict concerns), it may be appropriate to bring in another bank to run the go-shop process.[xxviii]

C. Board Reliance on Experts: Managing Conflicts of Interest, Fairness Opinions

The board, in exercising its business judgment as to the appropriate form and valuation of transaction consideration, may rely on experts, including counsel and investment bankers, in reaching an informed view. In Delaware, Section 141(e) of the DGCL provides protection from personal liability to directors who rely on appropriately qualified advisors. A board is entitled to rely on the expert advice of the company's legal and financial advisors "who are selected with reasonable care and are reasonably believed to be acting within the scope of their expertise," as well as on the advice and analyses of management.[xxix] In merger transactions, an investment banker's unbiased view of the fairness of the consideration to be paid and the related analyses provide a board with significant information with which to evaluate a proposed transaction. Since Delaware's 1985 *Smith* v. *Van Gorkom* decision, it has been common in a merger transaction involving a public company for a fairness opinion to be rendered to the board of the seller (and, sometimes, to the buyer). The analyses and opinions presented to a board, combined with presentations by management and the board's own long-term strategic reviews, provide the key foundation for the exercise of the directors' business judgment.[xxx] Courts reviewing the actions of boards have commented favorably on the use by boards of investment bankers in evaluating merger and other transaction proposals (although generally receipt of a fairness opinion by independent investment bankers is not required as a matter of law).[xxxi] The SEC staff also requires, in transactions subject to the proxy rules, detailed disclosure of the procedures followed by an investment banker in preparing a fairness opinion, including a summary of the financial analyses underlying the banker's opinion and a description of any constraints placed on those analyses by the board.

Particularly in situations where target directors are choosing among competing common stock (or other non-cash) business combinations, a board's decision making may be susceptible to claims of bias, faulty judgment and inadequate investigation of the relative values of competing offers. Because the stock valuation process inherently involves greater exercise of judgment by a board than that required in an all-cash deal, consideration of the informed analyses of financial advisors is helpful in establishing the fulfillment of the applicable legal duties.

In a stock-for-stock fixed exchange ratio merger, the fairness of the consideration often turns on the relative contributions of each party to the combined company in terms of revenues, earnings and assets, not the absolute dollar value of the stock being received by one party's shareholders based on its trading price at a particular point in time. Parties to a stock-for-stock merger customarily opt to sign a merger agreement based on the fairness of the exchange ratio at the time of signing, without a bring-down. This structure enhances the probability of consummating the merger by not giving either party a right to walk away if the fairness opinion would otherwise have changed between signing and closing.

Great care should be exercised by investment bankers in preparing the analyses that support their opinions and in the presentation of such analyses to management and the board. The wording of the fairness opinion and the related proxy statement disclosures must be carefully drafted to accurately reflect the nature of the analyses underlying the opinion and the assumptions and qualifications upon which it is based.[xxxii]

D. Perceived Banker Conflicts and Disclosure

It is important that banks and boards take a proactive role in encouraging the disclosure and management of actual or potential conflicts of interest both at the board level and among the board's advisors. In recent years, there has been a significant focus on financial adviser conflicts. As noted in *In re El Paso*, banks should faithfully represent their clients and disclose fully any actual or potential conflicts of which they are aware so that such conflicts can be managed appropriately.[xxxiii] Though boards cannot know and do not have a responsibility to identify every conflict their financial advisors may have, they should seek to ensure that these conflicts are brought to light as they arise throughout the transaction process, and to appropriately manage any such conflicts. These steps are vital to banks and boards avoiding liability from banker conflicts and failed disclosure. In the absence of disclosure and management of conflicts, among other results, a board may be found to have breached its fiduciary duty, the deal could be delayed, and deal protections could be compromised.

Courts and the SEC will scrutinize perceived conflicts of interest by the investment bank rendering the fairness opinion. Since 2007, FINRA's rules require specific disclosures and procedures addressing conflicts of interest when member firms provide fairness opinions in change-of-control transactions.[xxxiv] FINRA requires disclosure in the fairness opinion as to, among other things, whether or not the fairness opinion was approved or issued by a fairness committee, whether or not the fairness opinion expresses an opinion regarding the fairness of the amount or nature of the compensation to be received in such transaction by the company's officers, directors, employees or class of such persons, relative to the compensation to be received in such transaction by the shareholders, and disclosure of whether the compensation that the member firm will receive is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor, as well as whether any other "significant" payment or compensation is contingent upon the completion of the transaction, and any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion.[xxxv] Disclosure about previous relationships between the investment banker and the parties to the transaction is also required.

The Delaware courts have also had a voice in deciding what constitutes a conflict of interest on the part of financial advisors to a transaction. For example, although FINRA does not ban the practice of contingent fee arrangements for financial advisors, in some circumstances, certain contingent fee arrangements will cause Delaware courts to find triable issues of bias. In *TCI*, the Court held that the fact that the fairness opinion rendered by a special committee's financial advisor was given pursuant to a contingent fee arrangement—$40 million of the financial advisor's fee was contingent on the completion of the transaction—created "a serious issue of material fact, as to whether [that advisor] could provide independent advice to the Special Committee."[xxxvi] Although certain contingent fee arrangements in specific factual contexts have been questioned by the Delaware courts, contingent fee arrangements generally "ha[ve] been recognized as proper by [the] courts,"[xxxvii] as they "provide an incentive for [the investment bank] to seek higher value."[xxxviii]

The role of managing conflicts of interest is not limited to investment banks, and oversight over potential conflicts is within the scope of a board's fiduciary duties. In an important decision concerning the role played by outside financial advisors in the board's decision-making process, the Delaware Court of Chancery held in 2011 that a financial advisor was so conflicted that the board's failure to actively oversee the financial advisor's conflict gave rise to a likelihood of a breach of fiduciary duty by the board. In *In re Del Monte Foods Co. Shareholders Litigation*,[xxxix] the Court found that after the Del Monte board had called off a process of exploring a potential sale, its investment bankers continued to meet with several of the bidders—without the approval or knowledge of Del Monte—ultimately yielding a new joint bid from two buyout firms. While still representing the board and before the parties had reached agreement on price, Del Monte's bankers sought and received permission to provide financing to the bidders. The financial advisor was then tasked with running Del Monte's go-shop process, even though the financial advisor stood to earn a substantial fee from financing the pending acquisition. The Court stated that, although "the blame for what took place appears at this preliminary stage to lie with [the bankers], the buck stops with the Board," because "Delaware law requires that a board take an active and direct role in the sale process."[xl] The Court also faulted the board for agreeing to allow the competing bidders to work together and the bankers for providing buy-side financing without "making any effort to obtain a benefit for Del Monte and its stockholders."[xli] The case ultimately settled for $89 million, with the investment bank bearing roughly a quarter of the cost.

In 2014, in *In re Rural Metro Corporation Stockholders Litigation,*[xlii] the Delaware Court of Chancery found that Royal Bank of Canada aided and abetted fiduciary duty violations of the board of directors of Rural/Metro Corporation in its sale of the company to a private equity firm. The Court noted that, although RBC did tell the board upfront it was interested in providing staple financing, RBC never disclosed to the Rural board of directors that it was lobbying the private equity firm to participate in buy-side financing, even as the board sent RBC to negotiate against the private equity firm on behalf of the company. RBC was found to have failed to disclose certain critical information to the board "to further its own opportunity to close a deal, get paid its contingent fee, and receive additional and far greater fees for buy-side financing work."[xliii] The Court concluded that "RBC knowingly participated in the Board's breach of its duty of care by creating the informational vacuum that misled the Board," in part by revising its valuation of Rural downward so as to make it appear that the private equity firm's offer was fair to and in the best interests of Rural's shareholders.[xliv]

In 2015, the Delaware Supreme Court affirmed the Court of Chancery's ruling in *Rural Metro*, but emphasized its narrow nature and provided clarification on the practical steps boards and their financial advisors can take to manage potential conflicts.[xlv] The Court refused to adopt the Court of Chancery's *dictum* describing the financial advisors role as a "gatekeeper," stating that its holding was "a narrow one that should not be read expansively to suggest that any failure on the part of a financial advisor to prevent directors from breaching their duty of care gives rise to a claim for aiding and abetting a breach of the duty of care."[xlvi] The Court accepted the practical reality that banks may be conflicted, but put the onus on directors to "be especially diligent in overseeing the conflicted advisor's role in the sale process"[xlvii] and explained that "because the conflicted advisor may, alone, possess information relating to a conflict, the board should require disclosure of, on an ongoing basis, material information that might impact the board's process."[xlviii]

Del Monte and *Rural Metro* are examples of cases where, based on the records before them, the courts found serious improper behavior by the investment banks. Such cases have been rare and, moreover, the Court of Chancery has ruled, and the Delaware Supreme Court has affirmed, that a fully informed stockholder vote may effectively insulate a financial advisor from aiding and abetting liability, just as it may insulate directors.[xlix] In *Singh* v. *Attenborough*, the Delaware Supreme Court upheld the dismissal of claims that investment bankers had aided and abetted the directors of Zale Corporation in alleged breach of fiduciary duty in connection with the sale of the company. Amplifying its 2015 ruling in *KKR Financial*[l] (addressing "aiding-and-abetting" claims against corporate advisors), the Court held that, with the exception of a claim for waste, when a merger is approved by an informed body of disinterested stockholders and then closes, the business judgment rule applies, further judicial examination of director conduct is generally inappropriate, and "dismissal is typically the result."[li] The Court went on to emphasize that Delaware provides corporate advisors with "a high degree of insulation from liability by employing a defendant-friendly standard that requires plaintiffs to prove scienter and awards advisors an effective immunity from due-care liability."[lii]

In addition to state law requirements, in 2016 the SEC issued guidance related to disclosure of financial advisor fees in solicitations involving equity tender offers, a transaction structure often used to effect M&A transactions. The guidance provides that the board of a target company must disclose a summary of the material terms of the compensation of the target's financial advisor in its solicitation/recommendation statement. A generic disclosure saying the financial advisor is being paid "customary compensation" is not ordinarily enough—the disclosure must be sufficient to permit shareholders to evaluate the advisor's objectivity. The guidance provides that such disclosure would generally include the types of fees payable, contingencies, milestones or triggers relating to the fees, and any other information that would be material to a shareholder's assessment of the financial advisor's analyses or conclusions, including any material incentives or conflicts.[liii]

E. Use and Disclosure of Financial Projections

Financial projections are often prepared by the management of the target company (or of both companies in a stock-for-stock deal) and can play a critical role in the decision-making process of both the acquiror and target boards with respect to the amount and nature of consideration. These projections may also serve as the foundation for certain analyses supporting a fairness opinion given by a financial advisor. Despite their usefulness, the creation of and reliance on financial projections may trigger certain disclosure obligations under both Delaware law and SEC rules. Failing to understand and follow the disclosure requirements may result in costly shareholder litigation claiming that the company's disclosure to shareholders was inadequate and misleading, which could lead to delay in completing a transaction.

As it did in the *Netsmart* decision, the Delaware Court of Chancery often requires disclosure of management projections underlying the analyses supporting a fairness opinion.[liv] Courts have also indicated that partial or selective disclosure of certain projections can be problematic.

Not all projections will be deemed sufficiently material or reliable as to require proxy disclosure. Nor is the mere receipt or review of certain projections by parties or advisors to a transaction enough to require disclosure.[lv] For one thing, the development of financial projections is an iterative process, which often involves deliberation between the board (or special committee), the financial advisors and management as to which assumptions are reasonable. Additionally, financial projections often contemplate a base case, an upside case and a downside case, not all of which are necessarily material and required to be disclosed.[lvi] As explained in *In re Micromet, Inc. Shareholders Litigation*, "Delaware law does not require disclosure of inherently unreliable or speculative information which would tend to confuse stockholders or inundate them with an overload of information."[lvii]

In *In re BEA Systems, Inc. Shareholders Litigation*, the plaintiffs argued that certain financial data considered by BEA's financial advisor had been presented to the board and thus had to be disclosed.[lviii] The Delaware Court of Chancery found that neither the financial advisor nor the board considered the contested data reliable or actually relied upon that data in forming their views on valuation and that the information did not have to be disclosed, noting that disclosure of such unreliable information "could well mislead shareholders rather than inform them."[lix] The *BEA* case indicates that Delaware courts have not imposed *per se* disclosure standards for financial projections or other aspects of a financial advisor's work; case-specific materiality is the touchstone for disclosure.

The SEC also imposes its own disclosure requirements in transactions subject to the proxy rules. For example, the SEC typically requires disclosure of a target company's projections that were provided to the acquiror or its financial advisors, or the target's own financial advisors for purposes of giving a fairness opinion. While the SEC is receptive to arguments that certain projections are out of date or immaterial, it is normally the company's burden to persuade the SEC that projections that were provided to certain parties should not be disclosed. In light of the timing pressure facing many transactions, where even a few weeks' delay may add unwanted execution risk, companies may prophylactically disclose projections that they would have otherwise kept private. Such prophylactic efforts help accelerate the SEC review process and also help to minimize the likelihood that a successful shareholder lawsuit will enjoin a transaction pending further disclosure found to be required by a court. Nevertheless, a company must take heed not to include so many figures in its disclosure so as to be confusing or misleading to shareholders. Companies should consult with their legal and financial advisors well in advance of a filing to ensure that they are well informed as to how to strike the delicate balance between under- and over-disclosure of projections.

Delaware law and the views of the SEC staff on how much disclosure to require (both of target projections and, in the case of transactions involving stock consideration, buyer projections) continue to develop, however, and parties should consider at the outset of their negotiations the possibility that such disclosure may be required in the future.

Endnotes

---

[i] *Martin Marietta Materials, Inc.* v. *Vulcan Materials Co.*, 56 A.3d 1072 (Del. Ch. 2012), *aff'd*, 68 A.3d 1208 (Del. 2012).

[ii] *Depomed Inc.* v. *Horizon Pharma, PLC*, Nos. 1-15-CV-283834 (Cal. Sup. Ct. Nov. 19, 2015).

[iii] *Id*. at 2-3.

[iv] *See RAA Management, LLC* v. *Savage Sports Holdings, Inc.*, 45 A.3d 107 (Del. 2012).

[v] *PharmAthene, Inc.* v. *SIGA Techs., Inc.*, C.A. No. 2627-VCP, 2010 WL 4813553, at *2 (Del. Ch. Nov. 23, 2010) (citing *Hindes* v. *Wilmington Poetry Soc'y*, 138 A.2d 501, 502-04 (Del. Ch. 1958)).

[vi] Transcript of Oral Argument, *Global Asset Capital, LLC* v. *Rubicon US Reit, Inc.*, C.A. No. 5071-VCL (Del. Ch. Nov. 16, 2009).

[vii] *SIGA Techs., Inc.* v. *PharmAthene, Inc.*, 67 A.3d 330, 336 (Del. 2013).

[viii] *Id*. at 346-47.

[ix] *Id.* at 346.

[x] *Ev3, Inc.* v. *Lesh*, 114 A.3d 527 (Del. 2014).

[xi] *Id*. at 532-33.

[xii] *Id*. at 537.

[xiii] *Id*. at 530.

[xiv] *C&J Energy Servs., Inc.* v. *City of Miami Gen. Emps.' & Sanitation Emps.' Ret. Trust*, 107 A.3d 1049, 1067 (Del. 2014) (quoting *Barkan* v. *Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989)); *Paramount Commc'ns Inc.* v. *QVC Network Inc. (QVC)*, 637 A.2d 34, 44 (Del. 1994).

[xv] *Lyondell Chem. Co.* v. *Ryan*, 970 A.2d 235, 242 (Del. 2009).

[xvi] *In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 192 (Del. Ch. 2007).

[xvii] *In re Fort Howard Corp. S'holders Litig.*, C.A. No. 9991, 1988 WL 83147, 14 DEL. J. CORP. L. 699, 722 (Del. Ch. Aug. 8, 1988).

[xviii] *See, e.g., In re MONY Grp. Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004) (denying shareholder plaintiffs' request for injunctive relief based upon allegations that the MONY board of directors, having decided to put the company up for sale, failed to fulfill their fiduciary duties

by foregoing an auction in favor of entering into a merger agreement with a single bidder and allowing for a post-signing market check).

[xix] *In re Smurfit-Stone Container Corp. S'holder Litig.*, C.A. No. 6164-VCP, 2011 WL 2028076, at *19 n.133 (Del. Ch. May 24, 2011).

[xx] *In re Fort Howard Corp. S'holders Litig.*, CIV. A. No. 9991, 1988 WL 83147, (Del. Ch. Aug. 8, 1988); *see C&J Energy Servs., Inc.* v. *City of Miami Gen. Emps.' Ret. Trust*, 107 A.3d 1049, 1070 (Del. 2014) ("In prior cases like *In re Fort Howard Corporation Shareholders Litigation*, this sort of passive market check was deemed sufficient to satisfy *Revlon*.").

[xxi] *Fort Howard*, CIV.A. No. 9991, 1988 WL 83147, at *13.

[xxii] *In re Plains Exploration & Production Co. S'holder Litig.*, C.A. No. 8090-VCN, 2013 WL 1909124 at *5 (citing *In re Pennaco Energy, Inc.*, 787 A.2d 691, 707 (Del. Ch. 2001)).

[xxiii] *Koehler* v. *NetSpend Holdings Inc.*, C.A. No. 8373-VCG, 2013 WL 2181518 (Del. Ch. May 21, 2013).

[xxiv] *Id.* at *19.

[xxv] *Id.* at *20.

[xxvi] *In re Topps Co. S'holders Litig.*, 926 A.2d 58, 86-87 (Del. Ch. 2007); *see also In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 119-20 (Del. Ch. 2007).

[xxvii] *Id.* at *86.

[xxviii] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

[xxix] *Cinerama, Inc.* v. *Technicolor, Inc. (Technicolor II)*, 663 A.2d 1134, 1142 (Del. Ch. 1994).

[xxx] *See generally,* Leo E. Strine, Jr., *Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone,* 70 BUS. LAW. (May 2015).

[xxxi] *See, e.g., Smith* v. *Van Gorkom (Trans Union)*, 488 A.2d 858, 876-77 (Del. 1985).

[xxxii] *See Steinhardt, et al.* v. *Occam Networks, Inc., et al.*, C.A. No. 5878-VCL, at 15 (Del. Ch. Jan. 24, 2011) (ordering disclosure concerning, among other things, "what appear to be longitudinal changes from previous Jefferies' books that resulted in the final book making the deal look better than it would have been had the same metrics been used that were used in prior books.").

[xxxiii] *See, e.g., In re El Paso Corp. S'holder Litig.,* 41 A.3d 432 (Del. Ch. 2012).

[xxxiv] *See* Self-Regulatory Organizations, SEC Release No. 34-56645, 91 SEC Docket 2216 (Oct. 11, 2007).

[xxxv] *See* FINRA Manual, FINRA Rule 5150.

[xxxvi] *In re Tele-Commc'ns, Inc. S'holders Litig. (TCI)*, C.A. No. 16470, 2005 WL 3642727, at *10 (Del. Ch. Jan. 10, 2006).

[xxxvii] *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1005 (Del. Ch. 2005).

[xxxviii] *Id*.

[xxxix] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

[xl] *Id.* at 835 (internal quotations and citations omitted).

[xli] *Id.* at 834.

[xlii] *In re Rural Metro Corporation Stockholders Litig.*, 88 A.3d 54 (Del. Ch. 2014).

[xliii] *Id.* at 100.

[xliv] *Id.*

[xlv] *RBC Capital Mkts., LLC* v. *Jervis*, 129 A.3d 816 (Del. 2015).

[xlvi] *Id*. at 865.

[xlvii] *Id*. at 855 n.129.

[xlviii] *Id*. at 856.

[xlix] *See, e.g.*, *In re Zale Corp. Stockholders Litig.*, C.A. No. 9388-VCP, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015); *Singh* v. *Attenborough*, 137 A.3d 151 (Del. 2016).

[l] *Corwin* v. *KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015).

[li] *Singh* v. *Attenborough*, 137 A.3d 151 (Del. 2016), at 151-52.

[lii] *Id.*

[liii] SEC Division of Corporate Finance, Compliance and Disclosure Interpretations: Tender Offers and Schedules, Questions and Answers of General Applicability, last updated November 18, 2016, available at https://www.sec.gov/divisions/corpfin/guidance/cdi-tender-offers-and-schedules.htm.

[liv] *See In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 177 (Del. Ch. 2007); *see also Maric Capital Master Fund, Ltd.* v. *PLATO Learning, Inc.*, 11 A.3d 1175, 1178 (Del. Ch.

2010) ("[I]n my view, management's best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information.").

[lv] *In re 3Com S'holders Litig.*, C.A. No. 5067-CC, 2009 WL 5173804, at *3 (Del. Ch. Dec. 18, 2009) (holding that plaintiffs have failed to show how disclosure of full projections, instead of the summary provided by the financial advisors, would have altered the "total mix of available information"); *see also In re CheckFree Corp. S'holders Litig.*, C.A. No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007).

[lvi] *See David P. Simonetti Rollover IRA* v. *Margolis*, C.A. No. 3694-VCN, 2008 WL 5048692, at *10 (Del. Ch. June 27, 2008) (explaining that "Delaware law requires that directors disclose the substance of the investment banker's work, which usually depends in part upon management's best estimates," and holding that a proxy statement that discloses projections that "reflected management's best estimates at the time" instead of "lower-probability projections" meets the requirement to disclose projections that "would have been considered material by the reasonable stockholder").

[lvii] *In re Micromet, Inc. S'holders Litig.*, C.A. No. 7197-VCP, 2012 WL 681785, at *13 (Del. Ch. Feb. 29, 2012) (quoting *Globis Partners, L.P.* v. *Plumtree Software, Inc.*, C.A. No. 1577-VCP, 2007 WL 4292024 at *10 (Del. Ch. Nov. 30, 2007)) (holding that there is no legal requirement to disclose projections that present "overly optimistic 'what-ifs'").

[lviii] Transcript of Oral Argument on Plaintiffs' Motion For Preliminary Injunction and Rulings of the Court, *In re BEA Sys., Inc. S'holder Litig.*, C.A. No. 3298-VCL (Del. Ch. Mar. 26, 2008).

[lix] *Id.* at 94.