Corporate Governance

Case Update
Omnicare Inc. v. NCS Healthcare Inc.

In a split opinion, the Delaware Supreme Court holds directors breach their fiduciary duties in connection with a merger containing "lock-up" and "force the vote" agreements without a "fiduciary out" provision. ■ A recently decided Delaware case presents some interesting and troubling issues that will have to be considered in connection with many M&A transactions involving Delaware corporation law. The case is *Omnicare Inc. v. NCS Healthcare Inc.* (818 A.2d 914 (Del. 2003), opinion by Holland, J.). In the case, the Delaware Supreme Court reversed the Chancery Court and held that a merger transaction that included a "lock-up" of the votes of holders of a majority of the voting shares and did not include a "fiduciary out" provision that would permit the board to accept a better offer is invalid and unenforceable.

While there is much case law in Delaware on lock-ups, fiduciary outs and "defensive devices" generally, this case is noteworthy in several ways. First and foremost, the case seems to create new law, specifically that if shareholder approval is assured by locking up a majority of shares, the deal must contain a fiduciary out that permits the company to terminate the deal. Taken literally, the court is saying you must always have a fiduciary out where shareholder approval is a certainty before the vote is actually taken. This is a fairly dramatic extension of Delaware law, as it does not seem to permit any wiggle room or other exception for extenuating circumstances.

Second, most M&A lawyers and dealmakers who read the undisputed facts of what transpired and how the NCS board acted would conclude (at least before this decision) that the board acted wisely and prudently, and that the interests of the stockholders and creditors were well-protected.

NCS was in financial difficulty: It was in an industry that was experiencing very difficult times; it had retained investment bankers to explore strategic alternatives; its subordinated debt holders had appointed a committee to protect those interests; it was in default on its senior and its subordinated debt; it had played probably its only two possible suitors against each other to the point that the current offer would enable it to pay its debt and provide a modest amount for its equity holders; and it was confronted with an eminently believable "take–it-or-leave-it" scenario, which it elected to take. The NCS board agreed to a merger proposal that did not permit them a fiduciary out, and which required the agreement to vote for the deal by two of NCS's four directors, who as shareholders controlled 65% of the vote. Because the suitor making the offer, Genesis Health Ventures Inc., had lost out to the other bidder (Omnicare) in an unrelated deal, it made it clear that it would not serve as a "stalking horse," and gave the NCS board 24 hours to accept its final offer. Omnicare's offer was contingent on several matters, including a due diligence review. Despite the detailed record of the facts leading to the agreement to the lock-up provisions, the court struck down the deal protection devices agreed to by the Board of Directors.

Another noteworthy aspect of the case is that it was a 3-2 decision in which a polite but very strong dissent was penned by Chief Justice Veasey. That dissent asserts that the majority unwisely extended the Delaware law and created a "third rail" that future participants in mergers must deal with in structuring transactions. The Chief Justice also suggests that the majority's analysis of the case was created in a vacuum that ignores market realities, and that the decision is best regarded as an aberration with highly limited precedential value.

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It will be critical for those structuring control transactions under Delaware law to follow the developing case law after *Omnicare.* The extent to which the holding in the case will be applied is very much open. There are many justifications for distinguishing the case, and limiting its applicability to its narrow facts, as suggested by the Chief Justice. Alternatively, it is not a great leap, if you accept the basic rationale of the case, to envision the rule being expanded to apply to situations where preventing a merger that a board no longer recommends is not a "mathematical impossibility" as it was in *Omnicare;* i.e., when the voting agreements do not guarantee that the shareholders will approve the merger. Regardless of what may follow, this opinion stands as testament that in this post-Enron world, courts are going to be wary of any suggestion that directors have violated their fiduciary obligations to shareholders.

Facts

NCS began experiencing financial difficulties in 1999, and by early 2001 was in default on approximately $350 million of debt. NCS' stock price had sunk, and the holders of NCS' subordinated notes had formed an ad hoc committee to protect their interests. Efforts by its investment bankers to explore strategic alternatives were not generating positive results, but an invitation to Omnicare from NCS in the summer of 2001 to discuss a transaction began the chain of events that resulted in this case.

Over the next several months, NCS received a series of proposals from Omnicare, each for an asset sale in bankruptcy that would neither cover NCS' significant outstanding debt nor provide any recovery for NCS' stockholders. Thereafter, Genesis (contacted by the noteholders' ad hoc committee in January 2002) offered a transaction outside of bankruptcy which included repayment of NCS' senior debt and a payment of nearly $24 million to NCS' stockholders. The offer included certain exclusivity agreements, and Genesis indicated that any transaction would need to be "locked up" to prevent any subsequent higher bid. Genesis had previously lost a similar bidding war to Omnicare and wanted to ensure that history was not repeated.

After becoming aware of the Genesis negotiations, Omnicare responded by making an offer that did not call for a bankruptcy and included paying off NCS' debt as well as a payment to the NCS shareholders. However, Omnicare's revised offer was expressly conditioned on certain third party consents and completion of its due diligence. NCS used Omnicare's enhanced offer to seek to improve the terms of Genesis' offer.

Genesis significantly improved the terms of its offer, but, knowing of Omnicare's involvement, required that the transaction be approved within 24 hours or else discussions would terminate. The NCS board met and, after receiving advice from its counsel and financial advisers, decided that "balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's letter, results in the conclusion that the only reasonable alternative for the Board of Directors is to approve the Genesis transaction." The board then also voted to recommend the transaction to the shareholders, and a merger agreement and voting agreement were executed later that day.

The merger agreement provided that "NCS would submit the merger agreement to the NCS stockholders regardless of whether the NCS board continued to recommend the merger," and did not include a fiduciary out provision, which would have allowed the board to terminate the merger in the event NCS received a better offer. The voting agreement entered into by two members of the board, in their capacity as individual stockholders, provided that the two stockholders "agreed to vote all of their shares in favor of the merger agreement." As these two individuals collectively owned a majority of the voting stock, the voting agreement guaranteed that the merger would be approved by the shareholders.

After the merger and voting agreements were executed, but prior to the shareholder meeting, Omnicare increased its bid again to a price that was higher than the proposed Genesis transaction. The NCS board thereupon withdrew its recommendation of the Genesis transaction. However, since the merger agreement required the NCS board to put the Genesis transaction to a shareholder vote, and did not include a fiduciary out clause, the approval of the merger with Genesis was already a certainty. Omnicare and NCS minority shareholders brought suit.

The Lower Court's Opinion and Existing Law

The Delaware Chancery Court refused to prevent the merger from going forward. First, the lower court followed the business judgment rule and held that the decision to merge with Genesis itself was valid. This business judgment rule is intended to prevent the second guessing of business decisions made by directors. Courts presume that directors make business decisions on an informed basis and with a good faith belief that they are acting in the best interests of the corporation. It is the burden of the party challenging the board action to prove the presumption should be overcome.

The lower court also held that the "lock-up" and "force the vote" provisions were valid under Delaware law though such defensive devices were subject to enhanced judicial scrutiny. Under Delaware law, in certain situations the business judgment rule will not be invoked until after the court has examined directors' actions more closely. For example, under the standard articulated by the Delaware Supreme Court in Unocal Corp v. Mesa Petroleum Co. (493 A. 2d 946, Del.1985), when a board adopts defensive measures in response to a hostile takeover proposal, courts will more closely examine the directors' actions. The key components of this enhanced level of scrutiny are that "the directors have the burden of proving that they were adequately informed and acted reasonably."

The court found that the NCS board had reasonable grounds for believing a "danger to the corporate policy and effectiveness" existed, and the defensive response was reasonable in light of the perceived threat. The court found that because there was a reasonable possibility that NCS would lose the Genesis offer and not have any adequate alternative, the board acted reasonably in agreeing to the defensive devices. Accordingly, the lower court did not prevent the merger.

Supreme Court Reverses

In a rare 3-2 split, the majority of the Supreme Court of Delaware reversed the Chancery Court's decision. The majority assumed that the decision to enter into the merger was valid, but disagreed with the lower court's analysis of the "deal protection devices." The opinion outlines the analysis a court should use when scrutinizing a board, like the NCS', that has adopted "defensive devices that *completely* "lock-up" a merger. First, the court must look to whether the directors "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed." To satisfy this standard, the directors must prove that they were informed and acting in good faith. Next, the directors must show that their defensive actions were reasonable in relation to the threat posed. This second standard requires two showings: (1) that the response was not "coercive" or "preclusive," and (2) the response was within a range or reasonableness. A coercive response is one "aimed at forcing upon stockholders a management sponsored alternative to a hostile offer." A "preclusive" response is one that "deprives stockholders of the right to receive all tender offers or precludes a higher bidder from seeking control."

The court found that the NCS board's conduct did not meet the required standard of reasonableness. First, the court found that the defensive measures were "draconian" in that they were both coercive and preclusive. The court found that the merger was coercive not because the minority stockholders were required to vote for the merger, but because the agreements provided that the merger was already a done deal. "Those tripartite defensive measures—[the force the vote] provision, 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."

Further, and perhaps most importantly, the court held that even if the agreements were not coercive and preclusive, they were unenforceable because, due to the other agreements between the parties, the lack of a fiduciary out clause in the merger agreement "completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders." Where the minority stockholders have no effective power to influence a corporate decision, they need to rely on the board of directors to protect their interests. Thus, the court said, the board's agreement to limit the exercise of its fiduciary duty is invalid and unenforceable. The board was required to negotiate a fiduciary out clause with Genesis.

The court summarized that "the issues in this appeal do not involve the general validity of either stockholder voting agreements or the authority of directors to insert a [force the vote] provision in a merger agreement [both of which are authorized by Delaware law]. In this case, the NCS board combined those two otherwise valid actions and caused them to operate in concert as an absolute lock-up, in the absence of an effective fiduciary out clause in the Genesis merger agreement." Therefore, the merger agreement was unenforceable.

The Dissent Disapproves of the Majority's New "Rule of the Game"

Chief Justice Veasey's dissenting opinion, joined in by Justice Steele, concluded that the majority had created a new "rule of the game" under Delaware law. The dissent characterized the law created as follows:

> *The Majority invalidates the NCS board's action by announcing a new rule that represents an extension of our jurisprudence. That new rule can be narrowly stated as follows: 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. As we have noted, this bright-line, per se rule would apply regardless of (1) the circumstances leading up to the agreement and (2) the fact that the stockholders who control voting power had irrevocably committed themselves, as stockholders, to vote for the merger. Narrowly stated, this new rule is a judicially-created "third rail" that now becomes one of the given "rules of the game," to be taken into account by the negotiators and drafters of merger agreements. In our view this new rule is an unwise extension of existing p recedent.*

The dissent also focused on the assertion that the majority opinion evaluated the NCS board's decisions in isolation, without considering the circumstances of the negotiations. The dissent notes that the various defensive devices should not be viewed in a vacuum. Specifically, the Board had good reason to believe the Genesis offer would disappear if the board did not agree to its terms, and that Omnicare's offer was contingent on Omnicare's due diligence – a source of great concern to both the NCS board and the ad hoc committee of noteholders. Had NCS insisted on a fiduciary out provision, Genesis likely would have walked away from the transaction. The fiduciary out would have allowed the board to exit the merger, in the event a superior offer came along, without breaching the merger agreement. This was Genesis' fear from the beginning, as it had lost deals to Omnicare at the last minute in the past. It was reasonable for the NCS board to conclude the distinct possibility existed that NCS would have been left with no deal whatsoever if they did not agree to Genesis' lock-up demands.

In supporting his view that a lock-up without a fiduciary out should not be per se invalid, Chief Justice Veasey characterized the marketplace as follows:

> *Situations will arise where business realities demand a lock-up so that wealth-enhancing transactions may go forward. Accordingly, any bright-line rule prohibiting lock-ups could, in circumstances such as these, chill otherwise permissible conduct.*

The dissent also concluded that the directors' actions were not coercive, because they did not force the stockholders to vote for the transaction for any reason other than the merits of the transaction. Indeed, the majority of the voting shareholders made an informed decision to agree to the merger with full knowledge of the ramifications. Any "coercion" of minority shareholders, who knew that two individuals controlled 65% of the vote, was meaningless because the majority shareholders had made their decision. The dissent noted that although the voting agreement "precluded" a vote against the merger by the shareholders, "the pejorative 'preclusive' label applicable [under Delaware law] has no application here."

The dissent closes by suggesting that this case will have a deterrent effect on merger activity, unless the holding is confined to its narrow facts, in which case "negotiators may be able to navigate around this new hazard."

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