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United States, Delaware

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1 Types of transaction

How may businesses combine?

Corporations and other business entities may combine a number of ways under Delaware law. Section 251 of the Delaware General Corporation Law (DGCL) expressly permits mergers (one or more constituent corporations merge into and become part of another constituent corporation that continues its existence (the surviving corporation)) and consolidation (two or more constituent corporations are combined to form a new corporation (the resulting corporation)) which is created as a result of the consolidation. The DGCL specifically permits the merger or consolidation of:

- domestic (Delaware) and foreign (non-Delaware) corporations (section 252);
- a parent corporation and its subsidiary or subsidiaries – a so-called ‘short-form merger’ (section 253);
- domestic corporations and partnerships (section 263);
- domestic corporations and limited liability companies (section 264); and
- domestic corporations and joint-stock or other associations (sections 255–258).

In addition, a limited liability company, partnership or business trust may be converted into a corporation (section 265) and a corporation may be converted into a limited liability company, limited partnership or business trust (section 266). Section 271 sets forth the requirements for a corporation to sell all or substantially all of its assets.

The requirements for mergers between Delaware limited partnerships and mergers between Delaware limited liability companies are subject to separate statutes – the Delaware Revised Uniform Limited Partnership Act and the Delaware Limited Liability Company Act. It is beyond the scope of this chapter to discuss in detail business combinations of these types of entities except to note that many of the issues that arise in connection with the combination of corporations discussed below are also pertinent to the combination of alternative entities.

The consideration for business combinations can be cash, stock or a mixture of both and may be accomplished through asset purchases, stock purchases, tender offers for cash, or exchange offers for securities. Mergers may be accomplished through a number of structures. Typical structures include:

- a two-party merger, in which Corporation A (acquirer) acquires Corporation T (target) by merging T into A, with A becoming the surviving corporation;
- a three-party merger, in which two corporations merge into a third corporation, which is the surviving corporation. The third corporation is often created solely for the purpose of the transaction;
- a triangular merger, in which A forms a new Delaware subsidiary (S) into which T is merged. This permits A to acquire control of T without A being a constituent corporation; and
- a reverse triangular merger, in which S is merged into T, with T as the surviving corporation.

2 Statutes and regulations

What are the main laws and regulations governing business combinations?

The main sections of the DGCL governing the voting and formal requirements and mechanics of business combinations are found in subchapter IX, Merger Consolidation or Conversion (sections 251–267) and section 271 concerning the sale, lease or exchange of assets. Also relevant is section 141, which sets forth the duties of boards of directors. Director duties are also shaped by the extensive body of judge-made fiduciary duty law generated by the Supreme Court of Delaware (the final appellate court) and the Delaware Court of Chancery (a court that specialises in business disputes, particularly those arising in the M&A context). Other sections of the DGCL that are frequently relevant to business combinations include:

- section 144, which permits transactions between an corporation and interested parties;
- section 109, which concerns the adoption, amendment and repeal of a corporation’s by-laws;
- section 102, which concerns the contents of a corporation’s certificate of incorporation;
- section 242, which concerns changes to a corporation’s certificate of incorporation; and
- section 262, which concerns appraisal right of a stockholder in a corporation undergoing a merger.

In the United States, issues related to the internal affairs of corporations are a matter of state law – such as the DGCL – and issues related to the issuance of securities, regulation of securities markets, investor protection and disclosure are a matter of the national law of the United States, often referred to as ‘federal law’. As a result, mergers of public held corporations are also subject to extensive requirements under the federal securities laws, sections 13 and 14 of the Securities Exchange Act of 1934 being the most relevant to M&A transactions. The requirements of federal securities law relevant to M&A are discussed in the chapter on the United States contained in this volume.

3 Governing law

What law typically governs the transaction agreements?

Because Delaware law governs the internal affairs of a Delaware corporation, issues such as the voting requirements to effect a merger or the conduct of the board of directors in connection with the merger are governed by Delaware law for a Delaware corporation. The parties to a business combination may select the applicable law for the key transactional documents such as the merger agreement, stock purchase agreement, support agreements and employment agreements. Parties to these agreements typically select Delaware law. For certain types of agreements, in particular, financing commitments, it is not unusual for parties to select New York State law as the governing law.

4 Filings and fees

Which government or stock exchange filings are necessary in connection with a business combination? Are there stamp taxes or other government fees in connection with completing a business combination?

The completion of a merger under Delaware law requires the filing of a Certificate of Merger with the Delaware Secretary of State's office. The fee for such filing is nominal (currently \$239). Delaware does not impose a stamp or similar tax on mergers.

Business combinations in regulated industries (such as banking or insurance) may require additional filings with their primary state or federal regulator. In addition, publicly held corporations are typically required to make filings under the federal securities law. Transactions involving securities or assets of greater than \$68.2 million are required to make a pre-merger filing under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 with the Federal Trade Commission and the United States Department of Justice.

5 Information to be disclosed

What information needs to be made public in a business combination? Does this depend on what type of structure is used?

For a publicly traded Delaware corporation, the Securities Act and Exchange Act set forth comprehensive disclosure requirements. A business combination will typically require a stockholder vote. Publicly traded companies are required to provide a proxy statement that discloses material information concerning the proposed transaction so that the stockholder vote can be informed. Proxies typically include the background of the transaction, the principal terms of material transaction documents as well as copies of those documents, historical financial information about the company and the details of investment bankers' fairness opinions. The disclosure requirements under section 251 and section 262 of the DGCL are modest by comparison. In addition, under Delaware law, directors have a fiduciary duty of disclosure to provide stockholders with information that is material to their decision to approve or disapprove the transaction or to seek appraisal. Failure to make adequate disclosure has been the basis for enjoining transactions so that curative disclosures may be made.

6 Disclosure of substantial shareholdings

What are the disclosure requirements for owners of large shareholdings in a company? Are the requirements affected if the company is a party to a business combination?

Delaware law does not provide for specific disclosure requirements for owners of large shareholdings in a company as part of a business combination. That issue is covered by section 13 of the Exchange Act and the regulations promulgated thereunder, which is covered in the chapter on the United States contained in this volume. The fiduciary duty of disclosure may require disclosure of owners of large shareholdings or controlling shareholdings if that information would be material to the shareholders' approval of the merger.

7 Duties of directors and controlling shareholders

What duties do the directors or managers of a company owe to the company's shareholders, creditors and other stakeholders in connection with a business combination? Do controlling shareholders have similar duties?

Legal challenges to M&A transactions under Delaware law come in the form of private lawsuits by hostile bidders or, more often, by stockholders, either derivatively on behalf of the company or on behalf of a class of similarly situated stockholders. As a result, over the last century, the Delaware courts have promulgated an extensive body of decisional law pertaining to the obligations that directors,

controlling stockholders and corporations owe to stockholders in connection with M&A transactions. Although this decisional law often addresses interpretation and application of the statutory provisions of the DGCL, it even more frequently concerns application of judge-made concepts of fiduciary duty and other equitable principles.

At core, Delaware fiduciary duty cases are based on the duty of care (a director's obligation to act with due care and on an informed basis in decision making) and the duty of loyalty (a director's obligation to refrain from self-dealing and act in the corporation's best interest). However, the complex factual context of M&A transactions and the sheer number of decisions have resulted in the Delaware courts applying these two basic fiduciary duties in a wide variety of ways. It is nonetheless possible to discern four standards of review the Delaware courts are most apt to apply in assessing a legal challenge to an M&A transaction.

First is the business judgment rule, which, if applicable, means the courts will give deference to the business judgements of a corporation's directors, typically causing the legal challenge to the M&A transaction to fail.

Second, when a target responds to a proposed M&A transaction, particularly a hostile one, the courts review the defensive manoeuvres the target has employed to see whether those defensive manoeuvres are both reasonable and proportionate responses to a reasonably perceived threat to corporate policy under *Unocal v Mesa Petroleum*, 493 A.2d 946 (Del. 1985). Defensive manoeuvres, such as the poison pill and deal protection measures to lock up a deal (for example, termination fees, superior proposal provisions, and voting covenants found in merger agreements), are typically reviewed under *Unocal*.

Third, when a company has embarked on a transaction that has made a change of control inevitable (whether on its own initiative or in response to an unsolicited offer), the board must seek to get 'the best price reasonably available' for the stockholders under *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*, 506 A.2d 173 (Del. 1986). In general, Delaware companies are under no obligation to sell themselves and are free to 'just say no' to unwanted suitors. But under *Revlon*, once a change of control becomes inevitable, the directors are transformed into the auctioneers of the company.

Fourth, in transactions between an interested party and a corporation – for example, a controlling stockholder attempting to take a company private through a freeze-out transaction – the entire fairness doctrine applies. Under the entire fairness doctrine, the courts will look more closely at the transaction to determine both whether the transaction was the result of fair dealing and whether it transpired at a fair price.

8 Approval and appraisal rights

What approval rights do shareholders have over business combinations? Do shareholders have appraisal or similar rights in business combinations?

Section 251 of the DGCL requires that to approve a merger a majority of the outstanding stock of a corporation entitled to vote must vote in favor of a merger. Section 262 sets forth a shareholder's appraisal rights in a merger in which the shareholder is being cashed out of the target. No appraisal rights are available in a merger in which the consideration is exclusively stock. Mergers in which the consideration is mixed between stock and cash allow appraisal. Because shareholder approval is not required in the context of a tender offer, no appraisal rights are available in a tender offer. In an appraisal proceeding, the stockholder is entitled to its pro rata share of the going-concern value of the entity, which has been interpreted as the shareholder's proportionate share in the value of the entity exclusive of any synergies created by the merger. Delaware also allows a quasi-appraisal remedy when material facts relating to the stockholder's determination of whether to accept the merger consideration or seek statutory appraisal were not disclosed. Provided disclosure was insufficient, minority stockholders who did not

pursue appraisal are entitled to pursue a quasi-appraisal class action to recover the difference between judicially determined fair value and the merger price.

9 Hostile transactions

What are the special considerations for unsolicited transactions?

Delaware law allows several structural defenses to unsolicited or hostile transactions.

Section 141(d) of the DGCL permits a corporation to have a staggered board of up to three classes of directors. Because it can take three years to unseat a staggered board, this structure makes an attempt to replace the directors of the target board with individuals nominated by the acquirer more difficult and time consuming.

Section 203, the so-called 'control share' statute, regulates certain business combinations with 'interested stockholders'. The statute was enacted to balance between the benefits of unfettered market for corporate shares and the need to limit abusive takeover tactics. Unless a corporation opts out of section 203, business combinations between a public corporation and a stockholder of a large percentage of its shares (15 per cent or more) are subject to high voting requirements (66 per cent of the disinterested shares) for a period of three years subsequent to the interested stockholder achieving that status. Although section 203 has exceptions that hostile acquirer can potentially satisfy, it provides an effective means for a target to slow down the hostile acquirer.

Delaware law also permits corporations to adopt stockholder right plans (also known as the 'poison pill'). The poison pill grants stockholders of the target corporation special rights to purchase or sell securities under favourable or preferential conditions in the midst or as the result of a hostile takeover. The rights plan has been held to serve the legitimate purpose of giving the board issuing the rights the leverage to prevent transactions it does not favour by diluting the buying proponent's interest. The typical pill sets a threshold (typically a 10 per cent to 20 per cent ownership stake) beyond which the potential acquirer will be subject to substantial dilution.

Delaware corporations may enact 'advance notice' by-laws that require shareholders to give notice in advance of a meeting of their intention to nominate directors or submit proposals to a shareholder vote. Advance notice by-laws typically require that notice be given 30 to 60 days in advance of the meeting and they often require shareholders to provide detailed information concerning the proposed nomination or proposal the shareholder wishes to submit to a vote. The purpose of an advance notice by-law is to permit orderly solicitation of votes in advance of a meeting. But such by-laws also may serve as a restriction on the shareholders' right to nominate candidates for director.

10 Break-up fees – frustration of additional bidders

Which types of break-up and reverse break-up fees are allowed?

What are the limitations on a company's ability to protect deals from third-party bidders?

Delaware law permits reasonable break-up, reverse break-up or termination fees. Whether a break-up fee is 'reasonable' or not is determined by litigation in the Delaware courts. In determining the appropriate size of termination fee, factors the courts consider include the overall dollar size of the termination fee, the size of the termination fee and percentage terms (compared to both the equity value and enterprise value of the target), the size of the termination fee relative to the premium being offered in the transaction, and the degree to which the acquirer found the deal protection to be crucial to the deal. Delaware courts will also examine to what extent the target board has conducted either a pre-signing or post-signing market check on the transaction in determining whether *Revlon* and *Unocal* have been met. Termination fees measured as 3 per cent of the equity value of the target have generally been found to be reasonable.

Other types of deal protections that the Delaware courts have approved include:

- 'no-shop' and 'superior proposal' provisions (which limit the target board's ability to solicit and negotiate with other potential acquirers);
- 'force the vote' provisions (which allow the merger transaction to be put to a shareholder vote even if the board withdraws its recommendation for the transaction);
- matching rights (which give the initial acquirer to match any offer made by a second acquirer);
- standstill agreements (under which potential acquirers agree not to make offers for the target without the target's permission);
- support agreements (under which a stockholder commits to vote for a proposed transaction); and
- top-up options (under which the target grants an option to the acquirer that permits the acquirer to purchase the target's authorised but unissued shares after the acquirer has obtained voting control of the target in a tender offer).

Deal protection measures are subject to review under the *Revlon* standard to determine whether the deal protection measure frustrated the target board's ability to obtain the best price reasonably available for the target's stockholders. In addition, deal protection measures are subject to *Unocal* review as defensive measures. Accordingly, Delaware courts will examine whether the deal protection measures taken together have a 'preclusive or coercive power' in preventing an alternative transaction.

11 Government influence

Other than through relevant competition regulations, or in specific industries in which business combinations are regulated, may government agencies influence or restrict the completion of business combinations, including for reasons of national security?

Delaware law does not influence or restrict the completion of business combinations for reasons other than compliance with the DGCL or fiduciary duties.

12 Conditional offers

What conditions to a tender offer, exchange offer or other form of business combination are allowed? In a cash acquisition, may the financing be conditional?

Delaware law allows the conditioning of tender offers on the financing condition or other condition precedent. However, tender offers may not be structured in a manner that would make the tender offer coercive. In particular, a going-private tender offer must be subject to non-waivable majority of the minority tender condition, include a promise by the controlling shareholder to complete a prompt short form merger the acquirer obtains 90 per cent of the shares of the target, and not involve any retributive threats by the controlling shareholder (eg, threats to eliminate the dividend or delist the stock if the offer fails).

13 Financing

If a buyer needs to obtain financing for a transaction, how is this dealt with in the transaction documents? What are the typical obligations of the seller to assist in the buyer's financing?

Delaware law does not speak to how the acquirer will obtain financing. Financing issues are dealt with in transaction documents, and the acquirer and target are generally free to contract for whatever obligations to assist in financing that they wish. However, Delaware courts have scrutinised the use of 'staple financing' in transactions. In staple financing, the investment bank advising the target agrees to provide all or part of the financing to the acquirer. The availability of staple financing may enable the acquirer to pay a higher price to

Update and trends

The most significant trends affecting mergers and acquisitions of Delaware corporations in the last year have been the fact that nearly every transaction is the subject of a judicial challenge and increased sensitivity by the courts to conflicts of interest. For transactions over \$100 million, over 90 per cent of them are subject to shareholder challenge in court.

The bulk of these lawsuits present claims that sale processes that boards have put into place to shop companies before agreeing to merger agreements and deal protection measures contained in those agreements are lacking. For the most part, these cases have affirmed the validity of already well known and litigation-tested deal protection measures. In particular, no shop clauses that are balanced by a fiduciary out to consider superior proposals, matching rights that give the acquirer the right to match superior offers, informational rights that give the acquirer the right to receive the same information that the target disseminates to any other potential bidders, and termination fees in the neighborhood of 3 per cent of deal price have been widely upheld whether on their own or taken together. The courts will not require an extensive market canvas if the target board has 'quite impeccable knowledge' of the target business. *In re OPENLANE, Inc. S'holders Litig.*, 2011 Del. Ch. LEXIS 156 (30 September 2011) (denying motion to preliminarily enjoin a merger on the basis of a faulty *Revlon* process, despite the board's failure to employ many common *Revlon* procedures – such as an auction process, a fairness opinion, a broad pre-signing solicitation, a fiduciary out, or a post-agreement market check – because the board was intimately familiar with the company and its market segment and the board had significant stock ownership, which aligned their interests with those of the minority stockholders). Although not without limit, courts reject these challenges, demonstrating the Delaware courts' continued deference to independent boards that diligently supervise the sale process and are advised by un-conflicted advisers.

In contrast, the Delaware courts have shown little deference for transactions involving controlling stockholders or transactions involving board or adviser conflicts. In particular, the courts have been critical of financial advisers who have conflicts of interest. Delaware courts have 'examined banker conflicts closely to determine whether they tainted the directors' process.' *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 832 (Del. Ch. 2011) (preliminarily enjoining for 20 days a sale to a third-party acquirer where target board failed to

adequately oversee self-interested investment banker's role in sale process). Of particular concern are situations where the banker's conflicts were disclosed to the board and questions as to whether the board reasonably could rely on the banker's expert advice despite the alleged conflict. *Id.* at 836. Related to this trend is a requirement that proxy statements disclose any contingent compensation payable to the target's financial adviser and employment opportunities offered by and acquired to the target's CEO. *In re Atheros Communs., Inc. S'holder Litig.*, 2011 Del. Ch. LEXIS 36 (Del. Ch. 4 March 2011).

In addition, Delaware courts have taken a hard look at special committees and other methods used to sterilise conflicts. In particular, in *In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 30 A.3d 60 (Del. Ch. 14 October 2011), the Court of Chancery was highly critical of a special committee of independent directors established by the board of Southern Peru Copper to evaluate a transaction proposed by its controlling stockholder, the Grupo Mexico. Because the court found that the special committee was not 'well-functioning' and passive in its dealings with the controller, Grupo Mexico, the court determined that the merger was unfair to Southern Peru and its minority stockholders and awarded \$1.347 billion in damages, the largest amount ever awarded by the Court of Chancery. Similarly, in *In re El Paso Corp. S'holder Litig.*, 2012 Del. Ch. LEXIS 46 (Del. Ch. 29 February 2012), the court was highly critical of conflicts affecting the target's investment banker, Goldman Sachs, in particular its other work for the acquirer Kinder Morgan and the lead investment banker's ownership's interest in Kinder Morgan.

These two trends – increased filings and vigorous review of conflict transactions – have created a distinctive pattern. Delaware courts are routinely turning aside the steady stream of *Revlon* claims that a board has failed to obtain the best price reasonably available from a third-party acquirer in an arm's-length deal. But claims that involve conflict transactions are meeting with considerable success, generating sharply worded opinions, and, in some instances, giving rise to significant monetary liability for corporations to stockholder plaintiffs. Accordingly, deal lawyers should give focused consideration to identifying potential board, management and adviser conflicts early in the deal process, and where conflicts are discovered take effective steps to sterilise those conflicts through the use of independent and vigorous boards committees and advisers.

the seller. But the banking fees from providing the staple financing to the acquirer can often exceed the banking fees from providing advice to the target. As a result, Delaware courts have shown concern about how a banker's participation in staple financing can affect the incentives of investment bank providing advice to the target to get the highest price from the acquirer. To avoid conflict of interest, bankers advising targets should avoid participation and discussions about staple financing until after a merger agreement has been entered into and should seek permission from the target's board of directors before participating in discussions about providing staple financing to the acquirer.

14 Minority squeeze-out

May minority stockholders be squeezed out? If so, what steps must be taken and what is the time frame for the process?

Section 253 of the DGCL provides for a minority squeeze out (a so called short-form merger) if a party owns or acquires 90 per cent or more of the target stock. To effectuate a short-form merger, a board of directors of the acquiring party need only resolve to merge the target into the acquiring party. A short-form merger does not require a vote by either company's stockholders or approval by the target's board. In a short-form merger, a minority stockholder's protection is limited to its appraisal rights.

If the majority stockholder has less than 90 per cent of the target, it must pursue a long-form merger. If challenged, a squeeze-out long-form merger is subject to the exacting entire fairness standard of review. Even the use of a special committee of disinterested directors and a minority of the majority vote provision will only shift

the burden under entire fairness from the defendant directors to the shareholder plaintiffs. As a result, third party acquirers often use the top-up option under which upon acquiring a certain threshold of the target, the target will issue additional shares to the acquirer allowing it to top-up to the 90 per cent mark and thus effectuate a short-form merger under section 253.

15 Cross-border transactions

How are cross-border transactions structured? Do specific laws and regulations apply to cross-border transactions?

Delaware law does not restrict cross-border transactions. However, Delaware law only provides for merger or consolidation of Delaware corporations with corporations incorporated in Delaware or other states in the United States or District of Columbia. Accordingly, a non-US corporation seeking to merge with a Delaware corporation will typically create a Delaware subsidiary to effect the merger with another Delaware entity.

16 Waiting or notification periods

Other than as set forth in the competition laws, what are the relevant waiting or notification periods for completing business combinations?

Following the board's approval of a merger, the agreement of merger is submitted to the stockholders of each of the constituent corporations for a vote. Section 251(c) provides that this requires 20 days' notice of the meeting at which the vote shall be held. If the corporation's certificate of incorporation and by-laws permit action by written consent, the approval can be achieved instantaneously. However,

for public corporations, the requirements of federal proxy rules and stock exchange listing requirements will affect the speed at which a meeting can be held or a consent solicitation conducted.

17 Sector-specific rules

Are companies in specific industries subject to additional regulations and statutes?

Delaware corporation law does not subject companies in specific industries to additional regulations or statutes concerning business combinations. Certain regulated industries such as banking or insurance, however, may be subject to regulatory approvals by their primary state or federal regulators.

18 Tax issues

What are the basic tax issues involved in business combinations?

Delaware law does not speak to tax issues and business combinations. The significant tax issues for a business combination of a Delaware corporation are a matter of federal tax law.

19 Labour and employee benefits

What is the basic regulatory framework governing labour and employee benefits in a business combination?

Delaware law does not provide a regulatory framework for governing labour and employee benefits in a business combination. Executive compensation issues often arise in connection with shareholder challenges to business combinations. In particular, Delaware courts are frequently asked to review the propriety of change in control payments to officers and directors of the target as well as the indemnification of target officers and directors provided in connection with a business combination. In particular, Delaware courts will scrutinise these arrangements in the going private transactions to address the concern that an acquirer is using the promise of future employment, ownership interest, or compensation arrangements to skew the incentives of the seller's management in a merger negotiation. As a result, discussions about future employment, compensation or ownership by target management should wait until after board approval of the merger agreement.

20 Restructuring, bankruptcy or receivership

What are the special considerations for business combinations involving a target company that is in bankruptcy or receivership or engaged in a similar restructuring?

For Delaware corporations, Delaware law continues to govern the internal affairs of the corporation following its entry into bankruptcy or receivership. However, companies going through reorganisation are subject to United States bankruptcy laws and subject to the oversight of the United States Bankruptcy Court. Business combinations of bankrupt entities are typically achieved through a sale pursuant to section 363 of the United States Bankruptcy Code in which the debtor's assets are auctioned under the supervision of the Bankruptcy Court. Typically, the auction involves the identification of a stalking horse bidder at or around the time the corporation files for bankruptcy. The debtor corporation will typically enter into an asset purchase agreement with the stalking horse bidder, but competing bidders are permitted to come forward in the auction process. Although break-up fees and other deal protections are permissible, deal protection will receive greater scrutiny from the Bankruptcy Court than would similar protections in the context of a solvent company. In a section 363 sale, competing bidders and creditors of the debtor will be allowed to challenge the sale. Ultimately, the Bankruptcy Court will need to approve the 363 sale.

21 Anti-corruption and sanctions

What are the anti-corruption and economic sanctions considerations in connection with business combinations?

Anti-corruption and economic sanctions are not issues addressed by Delaware law. Those matters are the subject of federal law.



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