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accountability and the modern corporation

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Never mind, please vote no!

BY BRUCE L. SILVERSTEIN AND JOHN J. PASCHETTO

In *Omnicare, Inc. v. NCS Healthcare, Inc.* (818 A.2d 914 (Del. 2003)), the Delaware Supreme Court held that it was a *per se* breach of fiduciary duty for the board to authorise a merger agreement where *both* (i) the agreement included a 'force-the-vote' provision requiring that the merger be submitted to a stockholder vote even if the board later determined that it was not in the best interests of the stockholders for the merger to proceed; and (ii) there was a 'stockholder lock-up' by which one or more stockholders controlling the number of votes needed to approve the merger had contractually agreed to vote in favour of the transaction. The *Omnicare* Court reasoned that, taken together, these two deal-protection devices "operated in concert to have a preclusive and coercive effect" that was inconsistent with the fiduciary responsibilities of the directors.

So long as a majority of the stockholders remain free to vote as they please up to the moment of the stockholder vote, Delaware law does not require that merger agreements must contain a 'fiduciary out' of any kind.

The *Omnicare* Court went out of its way to explain that it was not criticizing the use of either of the two deal protection devices employed therein when used independent of the other. Nonetheless, even where there is no stockholder lock-up, in the wake of *Omnicare*, practitioners and deal-makers have questioned whether it is permissible to authorise a merger agreement that includes a strict force-the-vote provision (i.e., an agreement that requires a stockholder vote notwithstanding a changed recommendation and precludes the board from terminating the merger agreement to accept a 'Superior Proposal' or for any other reason that the board might determine, in the exercise of its fiduciary responsibility, that the proposed merger is not in the best interests of the stockholders). Additionally, a debate has arisen over whether the circumstances in which a board of directors may change its recommendation can be contractually limited.

This article suggests that, so long as a majority of the stockholders remain free to vote as they please up to the moment of the stockholder vote, Delaware law does not require that merger agreements must contain a 'fiduciary out' of any kind, and that it is permissible for a board of directors to authorise a merger agreement with strict force the vote provisions. Additionally, this article suggests that it is inconsistent with Delaware law for the board to authorise a merger agreement that contains contractual restrictions upon the circumstances under which the board may change its recommendation.

History of force-the-vote provisions

Under Delaware law, for a corporation to be acquired in a merger, the transaction first must be approved by the board and thereafter approved by the stockholders. In the case of a publicly-traded corporation, there typically will be a time lag of no less than thirty to sixty days from the date of the board action until the date the stockholder vote. Prior to 1998, it generally was believed that it was impermissible for a board to approve a merger agreement that required the transaction to be submitted to a stockholder vote if the board determined that it no longer supported the deal. This belief stemmed from the decision of the Delaware Supreme Court in *Smith v. Van Gorkom* (488 A.2d 858 (Del. 1985)), which noted, in dictum, that the main Delaware merger statute (Section 251 of the Delaware General Corporation Law (DGCL)) implicitly provided that directors could submit a merger to a stockholder vote only if they continued to recommend approval of the merger through the date of the stockholder meeting.

In 1998, the DGCL was amended to overrule the dicta in *Smith v. Van Gorkom*, by making clear that force-the-vote provisions are permissible in merger agreements. The statutory authority for force-the-vote provisions was first included in Section 251(c) of the DGCL. In 2003, a new Section 146 was added to the DGCL in order to clarify that force-the-vote provisions were permissible with respect to any 'matter' submitted to a stockholder vote.

Typically, but not always, a merger agreement containing a force-the-vote provision ▸▸

also will omit a provision that allows the board to terminate the agreement in the event of a changed recommendation. Although the 1998 amendment to DGCL does not specifically address the validity of such a practice, it generally is believed that the omission of such a fiduciary out fits 'hand-in-glove' with the inclusion of a force-the-vote provision.

Deal-protection devices used in *Omnicare*

The deal protection scheme in *Omnicare* combined a force-the-vote provision (with no fiduciary out) with contractual agreements by two stockholders holding sufficient shares to approve the transaction to vote for the merger. Thus, at the time that the *Omnicare* merger agreement was signed, the acquirer was assured that the merger would be approved by a majority of the stockholders, regardless of any superior offer that might be made for the target and/or any other reason why the proposed merger might no longer be in the best interests of the stockholders at the time of the stockholder vote. As the Delaware Supreme Court observed, from the moment the merger agreement was approved by the board, ultimate stockholder approval of the merger was a '*fait accompli*'.

Force-the-vote provisions unaccompanied by a vote lock-up are lawful

Omnicare did not invalidate force-the-vote provisions when not used in combination with a stockholder lock-up. (Nor, for that matter, did *Omnicare* invalidate stockholder lock-ups when not used in combination with a force-the-vote provision.) Moreover, force-the-vote provisions are expressly authorised by the DGCL. As long as the outcome of the stockholder vote is not a *fait accompli* (as was the case in *Omnicare*) it is improbable that there is any *per se* rule of fiduciary responsibility that would preclude a board from authorising a merger agreement that requires that it be submitted to a stockholder vote, regardless of the directors' change of heart. It also would seem to follow from the statutory authorisation of force-the-vote provisions that they need not be accompanied by fiduciary-out provisions allowing the target board to terminate the merger agreement in the event of a changed recommendation. Indeed, if such a fiduciary-out were legally necessary, then force-the-vote provisions would not have much value, as directors who decide that they can no longer recommend a merger would, in most cases, have reason to invoke the fiduciary-out, terminate the merger agreement, and thereby avoid a stockholder vote after all.

We leave to another day the circumstance where a majority stockholder seeks to acquire the minority stake of a majority-owned subsidiary. In such a situation, a force-the-vote provision would make the outcome of the stockholder vote a *fait accompli*, because the proponent of the merger also owns a majority of the subsidiary's stock. If the subsidiary is publicly traded and the delivery of the parent corporation's written consent must await the circulation or an Information Statement, of if the subsidiary's charter bars the use of a written stockholder consent to approve the merger (as was the case in *Omnicare*), there will be a period between the target board's approval of the merger agreement and the stockholder vote/consent. During that time, things can change such that the board of directors would no longer deem it advisable to proceed with the proposed merger. Since the board's change of recommendation would have no effect on the outcome of the vote, it is arguable that the merger agreement must contain a fiduciary-out permitting termination of the agreement under appropriate circumstances.

The board must retain its ability to change its recommendation

The very fact that a strict force-the-vote provision is permissible highlights the importance of the board's ability to provide stockholders with all information that is material to the decision whether to vote for or against the merger, and to change its recommendation where the board no longer believes that the proposed merger is in the stockholders' best interests. If, after approving a merger agreement, changed circumstances cause the board to determine that the proposed transaction is no longer in the best interests of the stockholders, the board probably has a fiduciary duty (as well as a federal securities law obligation in many instances) to communicate this determination to the stockholders. Indeed, it is arguable that withholding such material information would cause the outcome of the stockholder vote to be akin to a *fait accompli*, since the stockholders' awareness of superior options will have been artificially limited. Accordingly, notwithstanding the fact that many practitioners and dealmakers have advocated provisions in merger agreements that contractually limit the board's ability to change its recommendation to the circumstance where there is a 'Superior Proposal' (which, itself, is differently defined in various agreements), the better approach is that the board's ability to change its recommendation should remain essentially unfettered, so that the forced stockholder vote can be a fully informed, uncoerced decision whether to approve the proposed merger. ■

The better approach is that the board's ability to change its recommendation should remain essentially unfettered, so that the forced stockholder vote can be a fully informed, uncoerced decision whether to approve the proposed merger.

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