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Delaware Supreme Court Decision: Omnicare and the Invalidation of Absolute Shareholder Lock-Ups

In many mergers and acquisitions transactions, shareholder voting agreements, sometimes known as “lock-ups,” are used by an acquiror to ensure that a majority or other significant percentage of a target’s shareholders will vote in favor of the proposed acquisition. If a significant percentage of the target’s shareholders agree to approve the transaction, then the potential threat of a third party stepping in and undoing the deal is diminished.

The recent decision by the Delaware Supreme Court in Omnicare, Inc. v. NCS Healthcare, Inc., et al., No. 605 (Del. Sup. Ct. April 4, 2003), blocking the acquisition of NCS Healthcare, Inc. (“NCS”) by Genesis Health Ventures, Inc. (“Genesis”), has brought into question the future use of shareholder lock-up agreements in certain merger transactions contexts. The Court found that the merger agreement between NCS and Genesis and the voting agreements made by the majority shareholders were invalid and unenforceable because they were coercive and inconsistent with the fiduciary duties of the directors of NCS. However, the dissent in this rare 3-2 split decision expresses the hope that this decision will be limited to the unique facts of the case.

Omnicare Facts. NCS, a provider of pharmacy services to long-term care institutions, began looking for potential acquirers after experiencing financial trouble. NCS and Genesis engaged in discussions and were nearing an agreement when Omnicare, Inc. (“Omnicare”), an institutional pharmacy business, also made a proposal that was economically attractive. However, Omnicare’s proposal was conditioned upon certain events, including completing its due diligence and obtaining third party consents. In response, Genesis upped its offer with the condition that NCS had to approve the merger by the next day or the offer and any further discussions would be terminated. The terms of the offer featured (i) the requirement that the merger agreement be submitted to the shareholders for a vote, even if the NCS board of directors no longer recommended approval of the transaction, (ii) the omission of a fiduciary out clause from the agreement and (iii) the execution of voting agreements by two members of NCS’s board of directors who together owned 65% of the then outstanding voting power of NCS. The rationale behind these deal protection devices was borne out of Genesis’ prior unsuccessful bidding war with Omnicare in a different transaction and Genesis management’s desire to avoid being a “stalking horse.” Under such circumstances, the board of NCS approved the terms of the merger with Genesis.

After the NCS-Genesis merger agreement was executed, Omnicare continued its efforts to acquire NCS by restating its conditional proposal and issuing a press release disclosing its proposal, filing a lawsuit to enjoin the NCS-Genesis merger and announcing its intention to launch a tender offer. Months later, Omnicare ultimately made a firm offer to purchase NCS at a significantly higher price than that offered by Genesis. As a result, NCS’s board withdrew its recommendation of the Genesis merger agreement; however, by the terms of the Genesis merger agreement, the merger with Genesis still had to be presented to NCS’s stockholders for a vote, and because of the voting agreement, this vote was a foregone conclusion. Omnicare and NCS stockholders brought suit to stop the transaction.

The Lower Court’s Decision. The Delaware Court of Chancery upheld the merger agreement between NCS and Genesis. In doing so, it first applied the business judgment rule as the standard of review with respect to the merger transaction itself. The business judgment rule is a presumption that in making a business decision, the directors of the corporation acted on an informed basis, in good faith and in the honest belief that the actions taken were in the best interests of the corporation. The lower court found that NCS’s board, in approving the Genesis merger agreement, had

fulfilled its fiduciary duties and sought to acquire the best transaction reasonably available to the shareholders. With respect to the deal protection devices approved by NCS's board, the lower court applied the enhanced scrutiny test first set forth in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). The Unocal test requires that (i) a board has reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (ii) the defensive response chosen is reasonable in relation to the threat posed. Here, the lower court found that the threat to NCS was the possibility of it losing the Genesis offer and being left with no alternative and that the deal protection devices utilized were reasonable in light of the threat to NCS's corporate policy. Finding that both parts of the Unocal test were satisfied, the lower court found that the deal protection devices were valid and enforceable.

Enhanced Scrutiny of Deal Protection Devices. In reversing the lower court's decision, the Delaware Supreme Court disagreed with the lower court's analysis regarding the deal protection devices that protected the Genesis merger agreement. Relying on the second part of the Unocal enhanced judicial scrutiny test, as further defined by the Court in the Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995) decision, which held that a defensive response is reasonable if the defensive action was neither coercive nor preclusive and within a proportional range of reasonableness to the perceived threat, the Court found that the deal protection devices approved by NCS's board were not reasonable in relation to the threat brought about by the termination of the Genesis merger because they were coercive and preclusive. The combination of (i) the requirement that the board submit the merger agreement for a vote, a so-called "force-the-vote" provision, whether or not it recommended the agreement, (ii) the omission of an effective fiduciary out clause from the merger agreement and (iii) the execution of the voting agreements, effectively guaranteeing shareholder approval of the Genesis merger, was found to be coercive and preclusive because these provisions taken together achieved a *fait accompli* – in other words, these provisions made it "realistically unattainable" for a superior proposal to succeed. The Court believed that these provisions coerced the consummation of the Genesis merger and precluded the consideration of any other proposal; therefore, such deal protection devices were found to be unreasonable and unenforceable.

Lack of "Fiduciary Out" Clause. In addition, the Court found that these deal protection devices were unenforceable because of the lack of a "fiduciary out" clause in this merger agreement. In the Court's opinion, the absence of such a clause prevented NCS's board from discharging its fiduciary duties to the minority shareholders. When Omnicare proposed a superior transaction, the merger agreement prevented NCS's board from exercising its fiduciary responsibilities to the minority shareholders. The Court found this impermissible because NCS's board had a continuing obligation to discharge its duties as future circumstances developed after the merger agreement was signed. Therefore, in the context of a shareholder vote lock-up, the NCS board did not have the authority to accept a merger agreement that prevented it from exercising its fiduciary obligations.

Dissenting Viewpoints. Two justices dissented, agreeing with the lower court's findings that NCS's board had properly discharged its duties. The dissent criticized the bright-line per se rule adopted by the majority, which invalidates merger agreements with deal protection devices meant to lock-up stockholder vote that lack fiduciary out clauses, noting that the new rule would apply "regardless of (1) the circumstances leading up to the agreement and (2) the fact that stockholders who control voting power had irrevocably committed themselves, as *stockholders*, to vote for the merger." The dissent noted that there was a lengthy search and negotiation process, there were no other viable bids and the NCS board made a good faith decision that should only be subject to a review of the facts that existed at the time of its actions.

Applying Unocal, the dissent also found that had NCS's board not agreed to the Genesis merger agreement's protective clauses, deal discussions may have ended and the only viable bid may have disappeared. Therefore, in the face of such a threat, NCS's board acted reasonably in originally approving the merger agreement with Genesis. The dissent contends that the majority misapplied the Unitrin proportionality component of the Unocal test, as they failed to take into account "the reality that the contractual measures protecting this merger agreement were necessary to obtain the Genesis deal."

The dissent also disagreed with the majority's contention that the defensive measures were coercive and preclusive to the shareholders. The minority stockholders were deemed to understand that the controlling stockholders of NCS could approve a merger agreement without the vote of the minority. Because the minority were not needed for the vote, there was no

meaningful minority stockholder voting decision to coerce. Also, the shareholder-directors that held 65% of the voting power were well informed and executed the voting agreements in their capacity as stockholders.

The dissent foresees that by deterring bidders in transactions such as the NCS-Genesis merger and by requiring a fiduciary out clause, “the universe of potential bidders who could reasonably be expected to benefit stockholders could shrink or disappear.”

It expresses the hope that if this holding is confined to these unique facts, negotiators may be able to work around this decision.

Conclusion. The Omnicare decision is not about the general validity of stockholder voting agreements or the authority of directors to agree to a provision requiring the transaction be submitted to a shareholder vote regardless of whether the directors continue to recommend the transaction; these agreements and provisions are still valid. It remains to be seen how broadly or narrowly the Delaware courts will construe the Omnicare decision.

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For a more comprehensive discussion of the issues covered in this advisory, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult or one of the lawyers below.

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