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A new front in M&A litigation: Alleged violations of Delaware's antitakeover law

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Plaintiff stockholder litigation is increasingly alleging that discussions over merger support agreements and rollover agreements trigger the higher vote required by Section 203 of the Delaware General Corporation Law.

Plaintiff stockholder litigation against announced M&A deals continues to be a common feature of the U.S. M&A landscape, despite the prevalence of forum selection bylaws, the demise of disclosure only settlements and general skepticism by the Delaware courts. Over the last 18 months, however, plaintiff stockholders have opened a new line of attack by claiming that discussions and negotiations of support agreements to vote or tender in favor of a merger, and rollover agreements (at times requested by private equity sponsors), trigger Section 203 of the Delaware General Corporation Law.

What is Section 203?

Section 203 is an antitakeover statute in Delaware which provides that if a person or entity (an "interested stockholder") acquires 15% or more of the voting stock of a Delaware corporation (the "target") without prior approval of the target's board, then the interested stockholder may not engage in a business combination with the target for a period of 3 years unless the target stockholders approve the business combination by a 66-2/3% vote (excluding the vote of any shares owned by the interested stockholder) at a stockholder meeting.

If Section 203 is triggered in a negotiated merger, then a substantially higher stockholder approval threshold is required to approve the merger. In addition, certain representations of the target in the merger agreement may be breached potentially giving the acquirer a walk right. For example, an acquirer could argue that the required vote rep (which often has a lower materiality qualifier) is breached and that as a result of this breach the representations and warranties condition is not satisfied.

How are the plaintiff stockholders claiming Section 203 is triggered?

Plaintiff stockholders are claiming that discussions and negotiations for a support agreement (i.e., a commitment to tender into a tender offer or vote in favor of a merger) or a rollover agreement (i.e., an agreement to take equity in the surviving corporation or its parent in a merger, in lieu of the merger consideration paid to other target stockholders) between an acquirer, on the one hand, and stockholders of the target who either individually or collectively own 15% or more of the target's voting stock, on the other, resulted in the formation of an agreement, arrangement or understanding between the acquirer and those stockholders (and therefore the acquirer has ownership of that stock for purposes of Section 203) without receiving prior approval by the target's board.

The plaintiff stockholders are essentially arguing that these discussions evidence a "meeting of the minds" among the acquirer and those stockholders for the purpose of tendering, voting or rolling over equity. And the claim is that Section

203 was triggered because this meeting of the minds occurred at a time prior to approval by the target board of the merger agreement.

How has the Delaware Chancery Court ruled on these claims?

From a review of the cases, it appears that the courts are hesitant to expand Section 203 beyond its core purpose of preventing abusive tactics in the hostile takeover context. This common theme is evident in decisions by the Delaware Chancery Court on a number of recent occasions, including in *Flannery v. Genomic Health, Inc., et al., Emmanuel Kei, et al. v. Flint A. Lane, et al.* and *Hollywood Firefighters' Pension Fund, et al. v. James L. Dolan, et al.*, which acknowledge the overarching concerns of applying Section 203 outside the hostile takeover context.

In some cases the court has noted if the board of the target is aware that negotiations over a support agreement or rollover agreement are underway, and the target board nevertheless continues negotiating the merger agreement, that such actions are tantamount to implicit approval by the target board of the support agreement or rollover agreement for purposes of Section 203.

In other cases the court has focused on whether, in fact, there was any agreement or meeting of the minds prior to the time the merger agreement was signed. In a number of the decisions, it was clear that the parties to the support agreement or rollover agreement had not in fact reached any agreement or understanding—in one case, due to the acquirer reducing the price, and in another case due to disagreements over whether the stockholders signing the support agreement would be restricted from trading post-signing.

How can target boards best position themselves to defeat these claims?

As the Delaware Chancery Court notes in the decisions above, a board-controlled process is not what Section 203 was designed to address. Accordingly, targets should endeavor to have the record demonstrate that, together with their legal and financial advisers, the target board was leading the process for the deal and setting the rules, thereby making it clear that it is not an appropriate context for Section 203 to be applied.

It would also be best for the target board to telegraph to the acquirer that, in a situation where there is a meaningful likelihood that the acquirer may request these agreements from target stockholders, the acquirer needs to make sure that the target board is aware of those discussions at the outset. The decisions noted above held that, if the target board continues to negotiate the deal with that knowledge in mind, that fact can serve as implicit authorization for Section 203.

The most important takeaway is that the acquirer, the target board, and the target stockholders signatory to support agreements or rollover agreements, should not reach a meeting of the minds or act as if an agreement has been reached on these agreements until the target board approves the merger agreement. That should not be difficult. As many M&A practitioners are keenly aware, it is axiomatic that "there is no deal until there is a deal". Many negotiations have gone off the rails at the last minute, whether due to a price reduction, a request for a change in terms, a decline in the target's business or prospects or other developments, and until the merger agreement is signed there is no deal.

How should acquirers proceed when seeking support agreements or rollover agreements?

Ideally, it would be best for acquirers not to front run the target board on negotiations between the acquirer and target stockholders on support agreements and rollover agreements in a deal where Section 203 applies. Making sure the target board is "in the loop" on these discussions, including by sending draft agreements to the board rather than the individual stockholders in the first instance, tends to be helpful (although not dispositive) to defeat a plaintiff stockholder Section 203 claim. And given that target board authorization will ultimately be needed to exempt the support agreements or rollover agreements from Section 203, in most deals there is not much to be gained by acquirers in hiding the ball on these discussions.

What should deal participants expect going forward?

We do not expect that these claims will dissuade well-advised strategic acquirers or private equity sponsors from seeking support agreements or rollover agreements in public company M&A transactions. We also do not expect that the plaintiffs' bar will cease bringing these claims any time soon.

The record in public company M&A transactions is important. As noted above, so long as acquirers and targets have experienced counsel and pay heed to the guidance in the cases listed above, most times these alleged violations of Section 203 should be capable of being disposed of at the pleadings stage, absent unusual facts (which well-advised and careful negotiating parties and their counsel should be able to manage).

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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