



# SECURITIES REGULATION & LAW



## REPORT

Reproduced with permission from Securities Regulation & Law Report, Vol. 39, No. 21, 05/28/2007. Copyright © 2007 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

### CORPORATE GOVERNANCE

## Delaware Court Reaffirms Some Less Well-Known Principles of Corporation Law

By PETER B. LADIG AND STEPHEN B. BRAUERMAN

The Delaware Court of Chancery has recently reaffirmed some fundamental, yet less well known, principles that merit the attention of practitioners who advise Delaware corporations and their directors. In *Louisiana Municipal Police Employees' Retirement Sys. v. Crawford*, 2007 WL 582510 (Del. Ch. Feb. 23, 2007) and *In re Netsmart Technologies, Inc. Shareholders Litigation*, 2007 WL 926213 (Del. Ch. March 14, 2007) the Court of Chancery confirmed its respect for the shareholder franchise and emphasized that the laws governing the fiduciary duties of corporate directors are flexible. It also reaffirmed that there are no bright line rules with which directors can comply to avoid liability.

### I. The Cases

**A. Crawford.** In *Crawford*, the Court of Chancery was asked to enjoin the proposed merger of Caremark Corporation (Caremark) and CVS Corporation (CVS). Caremark and CVS entered into a merger agreement in

which Caremark shareholders would receive 1.67 shares of CVS stock for every share of Caremark. Neither company's shareholders would receive a premium, and management and the board would be divided evenly between the two companies. The merger agreement also contained certain deal protection devices, including "no-shop" and "last look" provisions,<sup>2</sup> and a reciprocal termination fee of \$675 million (approximately 3 percent of the total value of the transaction).

After the proposed Caremark-CVS merger became public, Express Scripts, Inc. made an unsolicited offer for Caremark. Although the Express Scripts offer valued Caremark at \$26 billion (\$3 billion more than the Caremark-CVS merger), Caremark found the Express Scripts offer deficient.<sup>3</sup> Following the Express Scripts offer, Caremark and CVS revised their deal to provide for a \$2.00 special dividend to Caremark stockholders if the merger was approved. In response, Express Scripts launched an exchange offer for all of the outstanding shares of Caremark on the same terms as its unsolicited

*Peter B. Ladig is a director and Stephen B. Brauerman is an associate at The Bayard Firm, P.A. in Wilmington, Del. The views expressed herein are the authors' own, and do not represent the views of The Bayard Firm, P.A. or its clients. Mr. Ladig and Mr. Brauerman can be reached at 302-655-5000.*

<sup>2</sup> The "no shop" provision prohibited both boards from speaking with a competing bidder unless the board concluded that the offer is a "Superior Proposal" or likely to lead to one. The "last look" provision obligated each board to disclose the terms of any competing "Superior Proposals" and allow the other party five days to match the superior bid. 2007 WL 582510, at \*3.

<sup>3</sup> Caremark explained that Express Scripts presented a horizontal merger (previously rejected by the board as impractical) that would have cost Caremark a number of clients and resulted in a highly leveraged entity. 2007 WL 582510, at \*4.

offer. Caremark and CVS countered by increasing the special dividend to \$6.00 per share upon approval of the merger. Recognizing that Caremark and Express Scripts were “in the throes of an all-out proxy contest for the votes of Caremark stockholders,” the Court of Chancery temporarily enjoined the stockholder vote on the Caremark-CVS Merger to allow stockholders time to digest new information Caremark disclosed during the proxy contest. *Crawford*, 2007 WL 582510, at \*5.

**B. Netsmart.** In *Netsmart*, the court considered whether to enjoin a shareholder vote to approve a “going private” merger in which two private equity firms would purchase Netsmart Technologies, Inc. (Netsmart) from its public shareholders. After the merger, private equity would continue to employ current management who, incentivized by option pools, would be motivated to increase the value of Netsmart. The shareholders challenged the merger because of management’s involvement in the negotiations despite “the fact that Netsmart management was keenly interested in the future incentives that would be offered by the buyers.” *Netsmart*, 2007 WL 926213, at \*11. The shareholders also challenged management’s refusal to pursue a strategic merger and its decision to solicit offers only from private equity firms.<sup>4</sup>

Although the special committee of the Netsmart board charged with running the sale process sought a “go-shop” provision from the buyers, which would have entitled Netsmart to continue to shop itself after the transaction was publicly announced, the buyers refused. This refusal was significant because Netsmart chose not to solicit strategic bidders on the assumption that a public announcement of a deal with a private equity firm would encourage superior bids from strategic buyers. Without the “go-shop,” Netsmart could not solicit these offers, and instead had to wait passively for them to come.<sup>5</sup> The agreement also contained a 1 percent reverse break-up fee payable to Netsmart if the buyers failed to close the deal and a 3 percent break up fee if Netsmart terminated the transaction in favor of a superior proposal.

**II. The Sanctity of the Shareholder Franchise.** *Crawford* begins by paying homage to the importance of the shareholder franchise. As the court explained,

Delaware courts place great faith in the discernment and acumen of shareholders. . . . Only in extraordinary circumstances will this Court . . . usurp the rights of shareholders to make their own informed decisions. When, as here, plaintiffs seek to prevent shareholders from making a fundamental decision, they bear a heavy burden to persuade

<sup>4</sup> While searching for a buyer, Netsmart did not actively seek strategic purchasers, instead concluding that the previous inability of management and its long time investment banker to find suitable strategic buyers would accurately predict its current ability to generate interest among strategic buyers. Although Netsmart made this decision at an “informal” meeting of the board (at which the company’s financial adviser made a presentation but no minutes were kept), Netsmart’s proxy statement asserted that the board considered a range of options at this informal meeting before abandoning its search for a strategic buyer. 2007 WL 926213, at \*10-11.

<sup>5</sup> The special committee was able to obtain a “window-shop” provision in the merger agree which allowed Netsmart to consider an unsolicited proposal that more or less met the standard definition of a “superior proposal.” 2007 WL 926213, at \*13.

the Court that shareholders are somehow unable to provide for their own protection, or that effective use of the corporate franchise is barred by some critical lack of information. *Crawford*, 2007 WL 582510, at \*1.

Although the court postponed the shareholder vote to approve Caremark-CVS Merger, it did so only for 20 days to allow Caremark shareholders time to consider the additional disclosures. By permitting a fully informed shareholder vote on the proposed merger, the court explained that “[t]he balance of the equities weighs in favor of permitting informed shareholders to speak directly to their fiduciaries without further intervention by this Court” *Id.* at \*13.

---

**. The *Crawford* court explained that “the ability of shareholders to vote in a fully-informed fashion, and the availability of appraisal rights to any shareholders that may be dissatisfied with the merger consideration shape the appropriate limits of judicial intervention.”**

---

Concerns about inadequate disclosure of material information also motivated the court’s decision to temporarily enjoin the shareholder vote to approve the merger in *Netsmart*. The court acknowledged that stockholders could suffer irreparable harm as a result of a flawed sales process, but found that in the absence of a competing offer it would be imprudent to “enjoin the only deal on the table, when the stockholders can make that decision themselves.” 2007 WL 926213, at \*28. Although the court ordered additional disclosures, it refused to enjoin a shareholder vote as the “granting of a broader injunction would therefore pose a risk that [the buyers] might walk or materially lower [their] bid.” *Id.* at \*29. As the court explained, “[it] would be hubristic for me to take a risk of that kind for the Netsmart stockholders, and the plaintiffs have not volunteered to back up their demand with a full bond.” *Id.*

In refusing to grant the broader injunction sought by the plaintiffs in each case, both the *Crawford* and *Netsmart* courts were mindful that the existence of appraisal rights mitigated the risk of irreparable harm to those shareholders who found the merger consideration inadequate. The *Crawford* court explained that “the ability of shareholders to vote in a fully-informed fashion, and the availability of appraisal rights to any shareholders that may be dissatisfied with the merger consideration shape the appropriate limits of judicial intervention.” 2007 WL 582510, at \*7. With the availability of appraisal rights, the *Crawford* court eschewed a direct discussion of whether the Caremark board fulfilled its fiduciary duties. It chose instead to focus only on whether the Caremark stockholders were fully informed, and concluded that “so long as appraisal rights remain available, shareholders fully apprised of all relevant facts may protect themselves.” *Id.* at \*13.

Vice Chancellor Strine took a similar view of the availability of appraisal rights in *Netsmart*. “In refusing to grant a broader injunction, I am also cognizant of the

availability of appraisal rights.” *Netsmart*, 2007 WL 926213, at \*29. The court emphasized that the potential failure of the Netsmart board to consider strategic buyers would factor into the appraisal calculus. “In an appraisal, the failure of the Netsmart board to test the market for strategic buyers in an active way will have relevance. Unlike past circumstances when the company was fully shopped and the resulting Merger price was deemed the most reliable evidence of fair value in appraisal, a future appraisal proceeding involving Netsmart will involve more uncertainty given the lack of an active market check and Netsmart’s micro-cap status.” *Id.* In the end, both decisions deferred to the combination of a fully informed shareholder franchise and appraisal rights to protect shareholders from questionable decisions by corporate boards in the merger context.

**III. Fiduciary Duty Law Not Governed By Bright Line Rules.** In addition to confirming the importance of an informed shareholder vote, both the *Crawford* and *Netsmart* decisions reaffirmed that the law of fiduciary duties is flexible and not governed by bright line rules. In both cases, the court refused to sanction the actions of corporate directors solely because previous opinions of the court had approved of similar decisions. The *Crawford* and *Netsmart* opinions demonstrate that the Court of Chancery will judge decisions affecting the fiduciary duties of the directors on a case-by-case basis depending on the particular circumstances of each scenario.

In *Crawford*, the court specifically emphasized that it did not excuse the breaches of fiduciary duty allegedly committed by the Caremark board. While the court did not directly address any claims related to the merger negotiations, it noted “serious questions” about those negotiations. *Crawford*, 2007 WL 582510, at \*9, \*13. One of the court’s more serious concerns related to the \$675 million termination fee. In support of the reasonableness of the termination fee contained in the merger agreement, the defendants cited previous Court of Chancery decisions upholding termination fees of greater than 3 percent. *Id.* at \*4 n.10. The court, however, declined this invitation to create a bright line rule and instead held that “[o]ur courts do not ‘presume that

all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal.’ Rather, a court focuses upon ‘the real world risks and prospects confronting [directors] when they agreed to the deal protections.’” *Id.*

In *Netsmart*, the defendant directors argued that the Court of Chancery’s previous approval of a post-agreement market check protected them because they used a post-agreement market check to ensure the fairness of the transaction to the shareholders. 2007 WL 926213 at \*19. While the court recognized that Netsmart’s status as a small-cap company prevented it from attracting significant attention in the marketplace while it was public, it found that the use of a post-agreement market check (previously approved for use by large-cap companies) may not have the same effectiveness with a small-cap company. *Id.* The court bolstered this conclusion by emphasizing that Netsmart did not show how a post-agreement market check would protect the shareholders of a small-cap company. Citing *Crawford*, it explained that “the mere fact that a technique was used in different market circumstances by another board and approved by another court does not mean that it is reasonable in other circumstances that involve very different market dynamics.” *Id.*

**Conclusion.** In these two cases, the Court of Chancery reaffirmed the fundamental principle that Delaware courts will not exercise their equitable powers to prevent stockholders from voting on a proposed transaction that is neither preclusive nor coercive, so long as adequate disclosures are present and appraisal rights are available, even where it has serious concerns whether the board fulfilled its fiduciary duties in agreeing to the transaction. The court also emphasized the flexibility of fiduciary duty law by refusing to establish bright line rules to govern the conduct of corporate directors, emphasizing that just because the Court of Chancery has previously approved a particular procedure does not mean that it will approve the same procedure in other circumstances. Attorneys who practice corporate law should keep these fundamental principles in mind when advising directors of Delaware corporations.