Introduction

This Model Agreement represents a hypothetical strategic buyer's first draft of a definitive acquisition agreement for the proposed acquisition of a publicly traded Delaware corporation in a stock-for-stock merger. The buyer is another publicly traded Delaware corporation; the target's stockholders would receive common stock in buyer. This draft agreement would be delivered by the buyer's counsel to the target's counsel to commence the negotiations on the definitive agreement.

The hypothetical fact pattern on which the discussions between the parties to the Model Agreement are presumed to have proceeded thus far is set forth following this Introduction. Key information in this fact pattern that will drive the negotiations between the parties includes:

- the proposed consideration is the buyer's common stock rather than cash;
- the target is a public company;
- the buyer is making a strategic acquisition of a complementary business; and
- although the target did not seek out the initial offer from this buyer, the target's board believes that this strategic alternative may be superior to the company's other reasonably available alternatives, including remaining independent or another acquisition transaction.

This Model Agreement and its associated commentary are not intended as an exhaustive treatise on the issues raised in the definitive agreement, or more generally with respect to any stock-for-stock strategic business combination between two public corporations. Rather, the Model Agreement should be used as a practical guide to aid counsel in the negotiation of such a transaction. This Model Agreement is prepared with both the novice lawyer and the experienced M&A practitioner in mind, although of course we cannot cover every possible negotiating point in this work.

In addition to the Fact Pattern, we have provided an annex discussing various considerations relating to the exchange ratio for the exchange of the target's stock for shares of the buyer's stock in the merger. We also have provided samples of three other agreements that are often part of the deal process: a Confidentiality Letter, an Exclusivity Letter, and a Voting Agreement, each with commentary. These sample ancillary agreements are all based on the same fact pattern, and should be reviewed in conjunction with the Model Agreement.

COMMENTARY

Commentary introduces each of the Articles of this Model Agreement and each of the ancillary agreements, and also follows many of the respective agreements' provisions. Our commentary explains the overall purpose of the Articles and provisions, the buyer's position and, in many cases, possible target objections or responses.

In the commentary, we have attempted to point out a range of typical responses by a target to the issues raised in this draft agreement, as well as some alternative buyer positions and, in some cases, possible compromises. No target would be likely to make every comment suggested in the commentary, however, and some buyers might choose to offer up a first draft with more or fewer concessions. Thus, although the commentary describes various positions a target or buyer might take on a particular issue, we do not suggest that any of these positions is the only correct approach to a particular provision. What is appropriate in a particular transaction will depend on the facts and each party's evaluation of what is most important to it, and achievable, in the transaction.

In addition, note that our commentary addresses issues in the order in which they arise in the Model Agreement, and this would not necessarily be consistent with the various issues' relative importance in any particular transaction, or with the order in which either party may choose, as a tactical matter, to raise them in a negotiation.

BUYER'S FIRST DRAFT; ROLE OF LEVERAGE; NEGOTIATING POSITIONS AND STYLE

As one would expect in a buyer's first draft, this Model Agreement has terms generally slanted to buyer favorable positions. The Model Agreement is not intended to be so buyer favorable in tone, however, as to adversely affect the negotiating dynamic between the parties. The buyer's counsel would often expect significant negotiation based on this draft, and, based on our fact pattern, the target has some leverage as it is a desirable strategic acquisition for the buyer with a variety of attractive alternatives. The Model Agreement recognizes this dynamic, with terms that are less buyer-favorable than might be proposed in a deal where the target is significantly smaller, less strategic to the buyer, or with fewer perceived alternatives.

Note that in this stock-for-stock transaction, the buyer is not delivering enough stock to trigger a requirement for its own stockholders to vote on the acquisition under stock exchange listing rules. The amount of stock being issued by buyer (representing approximately 15% of the combined company's outstanding common stock) may, however, represent a sufficiently significant position by target stockholders in the buyer post-closing to give target counsel leverage to seek some additional reciprocal representations and covenants.

The anticipation of possible requests for reciprocity also tempers the slant of the draft Model Agreement.

There are, of course, an infinite range of possible negotiating positions in connection with the terms of any acquisition. Nothing in the Model Agreement or ancillary agreements is intended to set any practice standard or expectation regarding the "right" way to negotiate a merger agreement for the acquisition of a public company. In any negotiation, the parties must take into account a wide variety of factors in determining which points to press and where to make concessions, including the relative size of the parties, perceptions of relative leverage or bargaining power, timing constraints, the industry and recent or otherwise significant transactions in the industry, the history of prior dealings among the parties or their advisors, the style of the respective parties and their advisors, and the priority issues for the respective parties in the transaction at hand.

Counsel will, of course, consider the perceived value of the transaction at hand along the value continuum between a "fully priced" transaction and a "low ball" bid. Other factors relevant to the negotiation of a particular issue may include the outcome of negotiations on other provisions in the acquisition agreement, and whether the buyer or its counsel has agreed to the proposed changes or similar changes in other similar transactions, and their relative concern about setting precedent for future transactions. For example, a buyer might be unwilling to accept a typical compromise position in some cases to avoid what it perceives as unfavorable precedent which could impact negotiations in later transactions.

Moreover, there is not one right negotiating style. Although various provisions are more or less favorable to a buyer or target company, it is rare that either side achieves a negotiated agreement which is entirely favorable to itself. The determination of whether to raise any particular argument, the intensity with which one negotiates any particular provision, and the ultimate outcome of the negotiations depend on numerous factors. There is an art in choosing what provisions are put forth initially in buyer's first draft, which issues to negotiate, and which terms to accept without objection. Such decisions are based on the facts relating to the particular negotiation as well as each counsel's training and experience. Thus, a particular buyer's counsel might offer up a very different first draft merger agreement and a particular target company counsel might choose to negotiate very different provisions, based on the particular facts of the deal at hand.

DIFFERENCES BETWEEN ACQUISITIONS OF PUBLIC COMPANIES AND ACQUISITIONS OF PRIVATELY HELD COMPANIES

As noted above, this Model Agreement relates to the acquisition of a public company in a strategic business combination for stock of a buyer that is a public company. Although there are many similarities between the acquisition

of a privately held company and an acquisition of a publicly traded company, there are also a number of key differences. Many of these differences stem from the fact that the real party in interest with respect to the transaction, the stockholder, is not at the negotiating table in a public company acquisition. Although one or more of the largest stockholders might be represented on the public target board of directors, generally the hundreds or thousands of public company stockholders cannot have a direct role in the negotiations.

The stockholders in a public company target are broadly dispersed and can only be solicited in compliance with federal securities laws and stock exchange rules. Securities law compliance is critical to both parties. In particular, both the target and buyer will be concerned about compliance with Regulation FD and avoiding any leaks or rumors about a possible transaction for both insider trading and other practical transaction concerns. A leak could force the target or buyer to make a public statement regarding the existence of negotiations between the parties before the transaction is fully negotiated, with an immediate impact on the target company stock's trading price as arbitrageurs jump into the stock. Employees, customers or suppliers may become concerned before the target company even knows it has a deal.

A jump in stock price fueled by rumors of a possible transaction can kill an otherwise viable deal, since the speculative price hike reduces the ultimate deal premium and the rumors can create unrealistic value expectations in the target stockholders. A buyer may be concerned, on the other hand, that speculation about the negotiation of a deal with the target company may attract competing bidders. These very real concerns may drive the parties to control the risk of inadvertent disclosure by, for example, restricting the information concerning the deal negotiations and diligence process to a very limited group of personnel at each company, and this can in some cases make the due diligence process problematic. Fortunately, much more information is available about a public company through its Securities and Exchange Commission ("SEC") filings than is typically available for a private company.

Also, the typical merger agreement for a public company acquisition does not contain any post-closing indemnity provisions. This is due to both the practical issues arising from the fact that there are a large number of stockholders and, probably more important, the concerns of the buyer about a possible competing bid, as discussed below. Thus, while representations and warranties are provided by the target, the utility of those representations is to provide confirmatory diligence, and to afford a "walk right" pursuant to the conditions to closing, if the parties learn prior to closing that the representations are inaccurate in material respects. If the representations are only discovered to be inaccurate following closing, the buyer has no practical recourse other than a possible misrepresentation or fraud claim against senior target management or, in some cases, substantial target stockholders. Occasionally, a public company merger agreement will have provisions for subsequent contingent payments, but these are relatively rare.

Speed between signing and closing is important in a public company acquisition, at least for the buyer. The buyer is usually concerned in a public company deal that a third-party bidder may propose a competing transaction to the target company board or stockholders. Unlike the typical scenario in a private company acquisition, there will always be a significant time period between the signing and public announcement of the public company deal and the closing. This is because either the stockholders must approve a merger at a stockholders' meeting, or there will be a minimum of a 20 business day period between commencement and closing if a tender offer structure is used. Buyers normally want to minimize this time between signing and closing as much as possible. The longer the period between signing and closing, the more opportunity there is for a third-party bidder to surface with a competing bid. The target may also want to reduce the time between signing and closing to minimize the possible negative impact on the deal from adverse business developments, which might give rise to a failure of a closing condition. A target board may, however, weigh its desire for speed against the value of a post-signing market check.

The negotiation of a public company acquisition is typically conducted by the target company management and/or the advisors to the target company's board of directors, including experienced M&A counsel, subject to the oversight of the board of directors. Even a small public company acquisition often has an investment banker involved on behalf of the target, both to provide a fairness opinion which can be relied upon by the target's board of directors and, often, to provide assistance in the sales process for, and negotiation of, the transaction. In addition, public company merger agreements are publicly available, permitting arguments with respect to market practice.

The target company board of directors owes fiduciary duties to the target's stockholders, as we discuss in further detail below. These duties will have a significant impact on the negotiation of the transaction and the final terms of the deal. Although the same duties apply to the board of a private company, the impact on deal terms and process is often more pronounced in a public deal. In part this is due to the fact that litigation is much more likely in a public company acquisition, with plaintiff stockholders frequently alleging in those actions that the target board of directors has not fulfilled the fiduciary duties it owes to such stockholders, and/or has failed to disclose all material information to the stockholders. These lawsuits are often brought by class action law firms who search for target stockholders willing to serve as named plaintiffs. Further, as noted above, because of the necessary delay in a public company acquisition between the signing and public announcement of the deal, and the closing, a competing bid is both more feasible and more likely in a public acquisition compared to a private company deal. In a public company acquisition, the negotiation of the "deal lock up" provisions addressing the target board's right to consider a competing deal can be important for the target board to demonstrate that it has indeed exercised its fiduciary duties.

Moreover, those terms may impact the likelihood and eventual success of a third-party bidder in launching a competing bid.

STOCK VERSUS CASH—STRUCTURE AND OTHER CONSIDERATIONS

An acquisition transaction like the one covered by the Model Agreement, where stock is being used as the merger consideration, typically is structured as a merger, and most often as a "reverse triangular" merger, where the target company survives the merger. It is also possible to structure the acquisition as a two-step transaction, using an exchange offer, in which the buyer's stock is exchanged for target company stock, in a transaction governed by Regulation 14D under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and a "back-end" merger. This Model Agreement provides for a reverse triangular merger.

Because the target is a public company, the shares being issued by the buyer must be registered on a Form S-4 Registration Statement with the SEC under the Securities Act of 1933, whether the transaction is structured as a one-step or a two-step transaction. Because buyer's stock is being issued, the buyer will typically make at least some representations about buyer's SEC reports and the financial statements they contain. Of course, the buyer must have adequate authorized common stock to permit the issuance of the shares in the merger or must obtain stockholder approval to increase the number of its authorized shares. As noted above, the target may seek to negotiate additional representations and interim operating covenants with respect to the buyer, in light of the stake the target stockholders are obtaining in the buyer's business, and in some cases, may insist on a condition that there has not been a "material adverse effect" as to the buyer's business. The commentary addresses these issues in more detail.

If this transaction were a deal in which the buyer was using cash consideration rather than issuing shares of its common stock, the Model Agreement would be different in a number of respects.

The first is that the transaction might be structured as a tender offer. Just as stock transactions can be structured as either a one-step merger or a two-step exchange offer and merger, the parties in a cash deal can either use a one-step merger or a two-step transaction with a tender offer pursuant to Section 14D under the Exchange Act, followed by a back-end cash merger. A tender offer, however, affords one key advantage, in that it may be completed more quickly

than a cash merger.[1] This is due to the fact that a tender offer can be closed 20 business days after commencement, and the tender offer documents are typically easier to prepare than the proxy statement required for a cash merger. In addition, no review or clearance of the offering documents by the SEC is required prior to the commencement of the offer and the dissemination of the tender offer materials. The proxy statement for a cash merger, however, cannot be mailed until at least 10 days after filing the proxy statement in preliminary form with the SEC, and if the SEC staff selects the proxy statement for review, the SEC staff frequently takes substantially longer than 10 days to review and provide comments. These comments must then be satisfactorily responded to in order to arrive at a definitive proxy statement that can be used to solicit approval of the merger. Although SEC comments may be issued on tender offer documents during the pendency of a tender offer, these comments can be resolved with an amendment to the tender offer filings, often without any significant delay in closing. As noted above, speed between signing and closing is very important to the buyer seeking to avoid a competing bid. It can also be important to the target board, who will want to minimize time between signing and closing to reduce the chances of some event giving rise to a risk of a material adverse effect or some other failure of a closing condition.

Despite the advantage of speed to closing afforded by a tender offer in a cash deal, the parties might not be able to use a tender offer structure for a cash acquisition in some cases. In particular, the parties might choose a one-step merger structure if there is significant concern that less than 90% of the shares would be acquired using the tender offer mechanism. If the buyer is not able to acquire at least 90% of the outstanding shares upon completion of the tender offer, the buyer would not be able to use a short-form merger to complete the second-step transaction under Delaware law. The buyer would then have to file a proxy statement covering the second-step merger with the SEC and receive clearance to mail to stockholders, resulting in a significant delay between the acquisition of majority control and completion of the second-step merger.

Also, if the transaction requires significant external financing for the merger consideration, a buyer would not likely use a tender offer, as the third party lenders might not be willing to close on the financing until the second-step transaction is completed. There also are regulatory restrictions on financings secured by public company stock, such as the target's stock. The speed of the tender offer also becomes less important if there are substantial regulatory approvals required that are likely to take more than 20 business days to obtain. Further, if the target negotiates a "go-shop" period following execution of the

1. In contrast, an exchange offer is not likely to close more quickly than a stock-for-stock merger. Although the SEC rules permit an issuer to distribute the prospectus/proxy statement relating to an exchange offer upon filing and prior to receipt of comments from the SEC staff on the registration statement, both an exchange offer and a merger for stock require preparation of a registration statement on Form S-4. There will be a 20 business day period between mailing and the consummation of the exchange offer, pursuant to the rules governing exchange offer; there will also be a 20 business day period between mailing and the stockholders' meeting, as a result of the SEC's rules regarding incorporation of reference. Accordingly, the exchange offer does not afford a significant time advantage in a stock-for-stock deal.

merger agreement, the speed afforded by a tender offer is not as important. If the parties do decide to pursue a two-step transaction, they will negotiate a single agreement providing for both the tender offer and second-step merger.

Even if the parties use a cash merger structure, there will be other differences between the governing merger agreement for the cash merger and a stock merger agreement such as the Model Agreement. For example, there would not be an exchange ratio, as the merger consideration can be stated as a fixed per share cash amount in all cases. This is because the value of cash does not fluctuate. In a stock merger, the value of buyer common stock will fluctuate with the trading market for such stock and the parties may therefore negotiate a variable exchange rate that takes such stock price changes into account. See the Appendix for a discussion of exchange ratios. The treatment of options and warrants may differ in a cash deal, although a buyer can choose to cash out these equity arrangements in either a cash or a stock deal. In addition, the buyer may try to use target's cash to fund the transaction, and may impose a minimum cash condition.

The target company would likely insist on representations that the buyer has sufficient available funds to pay the full merger consideration in a cash merger or, if financing is being sought, may insist on representations with regard to any financing terms or the commitment of its lenders, and may also seek representations regarding immediate post-closing solvency. There would, however, typically be fewer or no representations regarding the buyer's business. The buyer may need to make covenants regarding its efforts to obtain financing, and may seek the right to terminate the transaction upon payment of a "reverse" break-up fee to target in the event financing is not available. The target may resist this proposal, viewing such a provision as creating too much "optionality" for the buyer.

Further, in a cash transaction, the buyer might provide the target with a fiduciary termination right for a superior proposal by a third party in the initial draft merger agreement. In contrast, this fiduciary termination right is not included in the Model Agreement, which provides for a transaction using the buyer's stock as consideration. Accordingly, the target would need to negotiate to add this right. It should be noted, however, that in some cases a buyer may provide a fiduciary termination right in the initial draft merger agreement for a stock-for-stock transaction in the belief that this will lead to more efficient negotiation of issues more important to the buyer. As noted below, in a cash transaction under Delaware law, the target board of directors will have an obligation to determine that the transaction provides the best price and terms then available.

Mixed cash and stock deals raise similar concerns and also may present issues relating to the right of stockholders to elect one type of consideration over another.

AGREEMENT MECHANICS

Most merger agreements, whether cash or stock, have the same basic provisions. The Model Agreement is no different. As we explain in the commentary, the provisions in many of the sections of a merger agreement have impacts on provisions in other sections of the merger agreement.

First, there are sections governing the exchange of shares in the target company for the merger consideration, and, in the case of most cash deals, addressing appraisal rights. This part of the agreement typically includes a section covering the treatment of options and warrants as well. It also includes the provisions concerning the paying agent or exchange agent and the distribution of letters of transmittal to the target stockholders.

The Model Agreement also contains representations and warranties of both target and buyer. There are typically more representations made by the buyer in a deal for stock issued by the buyer than when the deal is for cash. The target's representations cover the same types of factual issues as in a private company acquisition, but may require less scheduling, due to both the publicly filed documents available to describe target's business, and the parties' desire to keep the deal team relatively small and the negotiations as short as possible to prevent leaks. Public company representations often do not have as many knowledge qualifiers, because the representations do not survive the closing. Inaccuracies in these representations would in some cases form the basis for a "walk right" if they are found to be materially inaccurate before closing.

There are a variety of covenants covering the parties' obligations in the period between signing and closing, and in some cases post-closing. One key set of covenants are interim operating covenants limiting the activities the target can undertake during the period between signing and closing. Also, there are covenants governing the preparation of the proxy statement and the calling of the target stockholders meeting to approve the transaction, the "no-shop" covenant, and the obligation of the target board to recommend the transaction, with appropriate "fiduciary outs" to certain of those obligations, e.g., covenants regarding regulatory approvals, obligations regarding directors and officers ("D&O") insurance, and other matters like Section 16 compliance and employee matters.

There are conditions to each party's obligation to close the transaction, which include conditions regarding stockholder approval, antitrust clearance, the absence of legal restraints, the absence of material adverse changes in the target (the "MAC" condition), the truth of representations and warranties, compliance with covenants, and other conditions. As noted above, the target will often be concerned about deal certainty upon announcement and will seek to limit these conditions to minimize the buyer's opportunities to decline to close the transaction.

There are termination rights for both parties in the event the transaction is illegal, the government issues an order against the transaction, the target stockholders vote the deal down, or the transaction is not closed by a "drop dead" date. Each party has a right to terminate for breaches of representations or covenants giving rise to a failure of condition, and these rights may be subject to a cure right. The buyer has a right to terminate for certain actions by the target, such as a change of recommendation adverse to the buyer, or the target's failure to reaffirm its support of the transaction or entering into a third-party agreement for an acquisition proposal or similar actions. The target may have a right to terminate in the event of a superior proposal, although in the case of the Model Agreement, the target must negotiate to obtain that right since the hypothetical buyer has not provided that right in its draft agreement.

In the case of some terminations, the target may be required either to reimburse expenses or to pay a termination fee to the buyer. For example, expense reimbursement and a termination fee may be required when the target's board has changed its recommendation or when target terminates for a superior proposal, if the merger agreement includes that termination right.

In the Miscellaneous section, the parties specify notice provisions, provide that the representations do not survive the closing, and set forth remedies, governing law, venue, no third-party beneficiary, and integration clauses. The Model Agreement also includes definitions, as is typical.

ADVISING THE TARGET BOARD OF DIRECTORS

In the target board's consideration of whether to pursue, entertain, or oppose a proposed merger, the directors must comply with their fiduciary duties under applicable state law. The practical application of fiduciary duty principles by the courts in the context of litigation over business combination transactions has shaped many of the provisions of public company merger agreements. The following discussion summarizes a number of the key principles in this area. More detailed descriptions of the applicable fiduciary requirements and how they are commonly dealt with in public company merger agreements are found in the commentary to the specific provisions of the Model Agreement and the ancillary agreements.

As noted above, there are a number of significant differences between a public company acquisition and a private company acquisition. As a result of these differences, counsel's role as an advisor to the board of directors may become much more significant in the public company context. Some of these differences were discussed in the prior section. First, the board's role may be heightened due to the fact that many of the real parties in interest, the public stockholders, are not involved in the negotiation process. Moreover, the board must address the significant period of uncertainty between the time a public company transaction is entered into and announced, and the time that stockholders actually vote. Finally, there is an active class action bar

that challenges most significant public company mergers: public company mergers typically are challenged as breaches of the fiduciary duty of the target company directors and disclosure. As a result of these circumstances, it is important that company counsel, and the directors, understand the legal standards applicable to any challenge to the board's conduct in connection with a merger, and that steps be taken to establish a clear record that their duties were satisfied.

Fiduciary Duties and Standards of Review. As discussed below, directors generally have the benefit of the business judgment rule, which severely limits the circumstances in which courts will second-guess business decisions made by directors. The rule is a presumption that directors have satisfied their duties of care and loyalty, and establishes a very significant burden for plaintiffs challenging business decisions. However, as further discussed below, the business judgment rule will not initially apply to a transaction involving a sale of control: this is the so-called *"Revlon"* doctrine. Under this doctrine, a court will examine whether directors approving a change in control transaction have taken reasonable steps to maximize value for stockholders. In addition, where a merger agreement includes deal-protection provisions, the business judgment rule may not apply unless the so-called *"Unocal"* standard is met, which requires that any defensive measures be reasonable in relation to a reasonably perceived threat. Both the *Revlon* and *Unocal* standards are sometimes referred to as "heightened scrutiny," and are often applied in litigation involving mergers. Finally, directors should be aware that the business judgment rule will not apply to transactions involving conflicts of interest affecting or relating to one or more directors; instead, the much stricter "entire fairness" standard will apply.

Throughout the transaction process, counsel should ensure that there is a clear record that directors are meeting their duties of care and loyalty, and that the directors can show that they have satisfied any enhanced requirements under *Revlon* and *Unocal*, and, finally, that any conflicts of interest have been appropriately addressed. These concepts are discussed in more detail below.

Duty of Care. The Delaware Supreme Court has explained the duty of care in the context of mergers as the duty "to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders." *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985). In determining whether a board has met its duty of care, a court will consider whether the board availed itself of all reasonably available material information about the subject of the decision. The board must evaluate a proposed business combination in light of the risks and benefits of the proposed transaction as compared to other alternatives reasonably available to the corporation, including the company's continuing as an independent entity.

The directors thus have the duty to exercise their fully informed business judgment to determine whether a proposal for a business combination is in the best interest of the company's stockholders. Directors must be diligent in examining critically the proposal and any alternatives, and must act with due care in considering all material information reasonably available, including information necessary to compare an offer to alternative courses of action.

The record should reflect that the directors played an active role in the process of selling a corporation. This does not mean that the directors must directly negotiate or draft documents. It does, however, mean that the board must have an active oversight role. Thus, it is important that the board be informed of the transaction as early as possible and that the directors be in a position to make decisions at critical junctures in the process, such as whether to pursue a proposed transaction, whether to enter into negotiations (exclusive or otherwise), whether to canvass the market for alternative proposals, and whether to agree to deal protection provisions. The directors should be provided with adequate materials at a time sufficiently in advance of meetings to be able to absorb such materials. Finally, the directors must have access to management and the company's advisors in considering a transaction. Counsel should make sure that the directors' deliberative process is being adequately documented through board minutes. Counsel should also give careful consideration to issues of attorney-client privilege.

Duty of Loyalty. In addition to the duty of care, the directors also owe stockholders a duty of loyalty, which requires that they act in the interests of all stockholders, and not in furtherance of personal interests. Thus, if a director has a personal interest different from the stockholders, such as an employment or consulting relationship, the participation of the director in board discussions or decisions about the transaction could implicate the duty of loyalty. Directors should be counseled to disclose any interest they may have in a matter beyond any interest as a stockholder. All material transactions or relationships that might influence a director's decisions concerning an acquisition, including relationships with other prospective acquirers, should be disclosed to the other directors.

The duty of loyalty may also be implicated if nonconflicted directors exhibit an inattention to their duties which rises to a level constituting "bad faith" or "conscious disregard of their duties." Deliberate indifference and inaction in the face of a duty to act constitutes a lack of good faith. Directors are well served by adequate information-gathering and deliberation in connection with an acquisition and by assuring that there is an adequate record of such process and deliberation. These matters are addressed above in the discussion of the duty of care.

Use of Recusal and Board Committees to Address Conflicts. Where one or more directors has a potential conflict of interest relating to the transaction being considered, it is often advisable to have interested directors recuse

themselves from some or all of the process. Alternatively, the board may establish a committee consisting solely of independent directors to consider the transaction (although, under the Delaware General Corporation Law ("DGCL"), the final merger agreement must be approved by the board itself). A board of directors may find it appropriate to establish a special committee to consider a transaction if the senior management or one or more directors are in discussions with potential buyers concerning possible participation in the continuing entity after the closing of the transaction. If a special committee is being implemented to provide a disinterested surrogate for the full board, the directors will need to consider whether additional independent advisors should be brought in to advise the committee and be careful to make clear that the committee is given sufficiently broad authority to fulfill its responsibilities on behalf of the board and in the interests of stockholders.

Business Judgment Rule. Generally, board decisions are protected by the common law "business judgment rule." This rule reflects the recognition by the courts that directors, not judges or stockholders, are best positioned to make business decisions. The rule provides an important defense to sustain well reasoned, informed, and good-faith business decisions by a board of directors. The Delaware Supreme Court has summarized the rule as follows:

> "The business judgment rule 'is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' . . . A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

Generally, the rule applies to transactions that do not involve conflicted directors or controlling stockholders.

Heightened Scrutiny. Even where directors are not conflicted, a merger will be subject to heightened judicial scrutiny in two circumstances: (1) where the transaction will result in a sale of control, and (2) where impediments to a competing acquisition transaction are implemented. Notably, almost all public company mergers fall at least into the latter category by virtue of the "deal protection" measures that most public company agreements contain, and that are discussed in detail in the commentary to the relevant provisions of the Model Agreement. Where applicable, the heightened scrutiny standard must be satisfied before the business judgment rule will apply.

Sale of Control—Revlon. Where the directors have determined that a sale of "control" or breakup of the company is "inevitable," their duty is "the maximization of the company's value at a sale for the stockholders' benefit." *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). "In the sale of control context, the directors must focus on one primary

objective—to secure the transaction offering the best value reasonably available for the stockholders." *Paramount Communications v. QVC Network, Inc.,* 637 A.2d 34, 44 (Del. 1994). A cash merger or other business combination in which stockholders are cashed out, or in which a stockholder or affiliated group of stockholders of the buyer controls the continuing entity, is generally viewed as a "sale of control," because such a transaction represents the stockholders' only opportunity to receive a control premium. Thus, an acquisition transaction that is primarily a cash transaction will be subject to *Revlon*, and if the directors decide to pursue a sale of the company for cash, the target board's obligation is to obtain the best available terms for the stockholders. Significantly, in any court challenge, directors would have to show that their actions were reasonable in pursuing that goal before receiving the benefit of the business judgment rule.

Not every merger is a "sale of control," however. Delaware courts have held that a stock-for-stock merger, where a majority of the shares in the combined entity will continue to be held after the merger by a "fluid aggregation of unaffiliated shareholders representing a voting majority," is not a sale of control. Of course, even in a stock-for-stock merger, a board must continue to exercise due care, reviewing all reasonably available information concerning the transaction and other alternatives.

When *Revlon* applies, there is no one method of obtaining the best value that is required, and the board has reasonable latitude in determining the method of sale most likely to produce the highest value for all the stockholders. *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009). One method to assure that the directors have obtained the "best" available price is to conduct a public auction of the company. However, directors may determine that such a process would harm the corporation, or not be acceptable to a potential buyer. Accordingly, Delaware courts have sometimes accepted as reasonable directors' reliance on a pre-signing "market check" in which private inquiries to the most likely bidders have been made.

In other cases, courts have approved use of a post-signing market check, where competing bidders may have a reasonable opportunity to express interest. Post-signing market checks may include "go-shop" provisions, allowing the company to contact potential competing bidders, or may be "passive;" that is, structured so that the company may only talk to bidders it has not solicited. Delaware courts have held that in determining the adequacy of the offer in a sale of control, directors may approve a transaction without employing an auction or pre-signing market check, so long as they are able to demonstrate that they possessed a "body of reliable evidence" on which to base their decision. The Delaware Supreme Court has held that there is "no single blueprint" for obtaining the necessary evidence to satisfy *Revlon* duties. *Barkan v. Amsted Industries*, 567 A. 2d 1279, 1287 (Del. 1989), *affirmed*, 637 A.2d 34 (Del. 1994).

Where the *Revlon* doctrine may be implicated, it is important for counsel to explain this legal standard to directors early in the process so that they will be in a position to make a fully informed decision as to the process that they believe is reasonably likely to maximize value for the stockholders. Accordingly, at the initial stages of a process, directors should be presented with alternative methods for finding the best price and positive and negative aspects of these methods. Advice from the company's financial advisor may be very helpful to the directors on these issues. In litigation, the focus on these issues may be greater where potential conflicts are present. For example, where a company is sold for cash to a financial bidder that intends to retain top management, and perhaps provide them with equity stakes in the continuing entity, special care must be taken to make a clear record that such conflict did not interfere with the value maximization process. This may involve greater board involvement than in other situations and, in appropriate situations, the use of a special committee and separate advisors, who are independent of management.

Deal Protection Provisions—Unocal. As previously noted, there is generally a significant interim period between the time a public company merger is announced and the time of a stockholder meeting to approve the transaction. During this period, the buyer, which has committed to purchase the company, is at risk of competing bidders topping the deal. Buyers thus often insist on provisions that may deter or impede competing offers. For example, a merger agreement typically includes a covenant prohibiting the target from soliciting other bids or negotiating with another interested bidder (a no-shop covenant). However, this no-shop covenant typically has exceptions that permit the target company to provide confidential information and enter into discussions or negotiations relating to an unsolicited competing bidder if certain conditions are met.

There are also often restrictions on the target board's right to change its recommendation in favor of the transaction, along with conditions which, if met, allow such a change. Finally, while there is often a right of the target to terminate the agreement for a superior bid, the right often has a number of conditions that give the first buyer an advantage in any ensuing bidding contest. These conditions often include the payment of a breakup fee, and a period in which the first buyer is permitted to match the competing bid (and has the right to complete the transaction if it does match the competing bid). In the event that the agreement does not provide such a right to terminate the merger agreement in favor of a superior proposal, the agreement is said to have a "force-the-vote" provision, whether or not the agreement specifically so states.

The merger agreement typically provides for a substantial fee (a "breakup," "termination," or "topping" fee), and sometimes expense reimbursement, payable by the target in cash if the transaction is terminated due to a change in the target board's recommendation, or in the event of a termination for a superior proposal, or for other reasons relating to a competing bid. In addition,

acquirers will often insist on a voting agreement with significant stockholders of the target. See the Comments to Sections 4.4, 4.6, 7.1 and 7.3 as well as the Voting Agreement for additional information regarding the negotiation of these provisions.

These provisions are complex, and are often the subject of litigation. It is critical that counsel explain these provisions to directors and obtain their input. The provisions may be subject to heightened scrutiny in litigation under the *Unocal* doctrine mentioned above which requires that defensive measures be reasonably necessary to protect a legitimate corporate interest and (2) be reasonably tailored to achieve this purpose. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 2d 946 (Del. 1985). The Delaware Supreme Court has confirmed that the *Unocal* enhanced judicial scrutiny is applicable to a Delaware court's evaluation of deal protection measures designed to protect a merger agreement. The Delaware Supreme Court has also held that the initial burden is on the target company directors to demonstrate that (1) they had reasonable grounds for believing that a threat to corporate policy and effectiveness existed and (2) that they took action in response to the threat that was neither coercive nor preclusive and that was within a range of reasonable responses to the threat perceived. *Omnicare Inc. v. NCS Healthcare, Inc.,* 818 A.2d 914 (Del. 2003). In addition, if the board is relying on the post-signing period as a market check in a merger that constitutes a sale of control, the deal protection provisions may be subject to heightened scrutiny under the *Revlon* doctrine.

If a target board reasonably concludes that a merger provides enhanced stockholder value, the board may conclude in the exercise of its business judgment that contractual provisions such as a no-shop clause, a breakup fee, a force-the-vote provision, or a voting agreement with one or more significant stockholders are necessary to induce a bidder to agree to the desirable business combination. Because these provisions may deter or preclude alternative bids which may offer a better price to the stockholders, the target board must analyze these provisions to determine that they are not so broadly drawn that they would deter competing bids offering substantially greater value to the stockholders.

A no-shop clause will likely be found to be enforceable under Delaware law if a target board concludes that it was reasonably necessary to induce an offer for an attractive transaction, and if the board is permitted to consider a "superior" bid. However, a target board cannot agree to an absolute exclusivity provision prohibiting the board from considering any third-party bids. The "decision not to negotiate must be an informed one" and "an agreement foreclosing all opportunity to discuss alternatives is the legal equivalent of willful blindness." *Phelps Dodge Corporation v. Cyprus Amex Minerals Co.*, CA No. 17398, 1999 De. Ch. Lexis 202 (Del. Ch. 1999). See Comment to Section 4.4 of the Model Agreement for additional information concerning no-shop covenants and "fiduciary outs."

Similarly, while breakup fees have been upheld in a number of cases, a fee of sufficient magnitude might be viewed as preclusive, coercive, or unreasonable under the *Unocal* standard, because it could deter or preclude bids which would offer substantially more value to stockholders than the deal in hand. A target board must therefore consider whether the size of any proposed "breakup" fee would deter other bids of substantially greater value than the deal being considered. See the Comment to Section 7.3 of the Model Agreement for additional information regarding termination fees generally.

As noted above, a buyer may also seek to enter into a voting agreement with one or more significant stockholders who agree to vote in favor of the transaction. A board cannot, of course, restrict the stockholder's individual ability to contract, but may be requested to approve the voting agreement or, alternatively, the definitive acquisition agreement with the target may be conditioned on the stockholder entering into the voting agreement. The board's approval of the voting agreement is typically sought to avoid negative effects to the buyer under Section 203 of the DGCL, which generally requires a supermajority vote for certain business combinations for three years if the buyer obtains more than 15% of the target's stock without board approval. See the Introduction to the Voting Agreement for additional information regarding voting agreements.

In *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A. 2d 914 (Del. 2003), the Delaware Supreme Court considered the board's duties in connection with a stock-for-stock merger in which the agreement did not contain a right on the part of the board to terminate the transaction for a superior offer, but instead included a "force-the-vote" provision. The court held that the failure of the board to retain a termination right breached the board's fiduciary duty when the target's stockholders representing a majority of the voting stock had entered into voting agreements in favor of the transaction. If the target board were to recommend against the transaction due to the receipt of a superior acquisition proposal, the transaction would still proceed, and therefore the combination of provisions was viewed as preclusive of competing deals.

Liability Issues. While directors may in theory be liable for violating a breach of the duty of care, corporations are generally permitted to adopt a provision eliminating personal liability of directors to the corporation for money damages for such breaches. *See e.g.*, DGCL Section § 102(b)(7). Counsel should review the corporation's charter and bylaws to make sure that such liability protection is present. In addition, counsel should review the indemnification and advancement provisions in the target's charter, bylaws, and separate indemnification agreements. These matters should be reviewed at the beginning of the process, because once the transaction closes, the directors may no longer be involved with the surviving entity, but could be at risk for lawsuits challenging their conduct as directors prior to the closing of the transaction. The provisions that are in place should be reviewed and considered in connection with the provisions of the merger agreement that

provide for indemnification and D&O insurance going forward. See Comment to Section 4.17 of the Model Agreement for additional information concerning such covenants.

CONCLUSION

This summary of some of the major issues covered in the Model Agreement and key issues to be considered by counsel in a public company acquisition is intended as an illustrative introduction to the many factors that must be considered in negotiating a public company merger agreement. Many of these issues are explored in considerable depth in the Comments to the Model Agreement, which also strive to provide illustrative issues to be raised by both buyer and target counsel on various provisions in the Model Agreement. Of course, practitioners should also keep in mind that practices evolve and the law continues to develop over time.