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How to avoid a flawed mergers and acquisitions process

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The recent decision of the Delaware Supreme Court in *Omnicare Inc. v. NCS Healthcare Inc.* has important implications for the use of so-called deal protective provisions in merger and acquisition transactions.

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This decision deals with the problem courts have had historically with deal protective provisions, which may deprive shareholders of their right to approve or reject the transaction recommended by the company's board of directors. While a sale of a company is generally orchestrated by a company's senior management in cooperation with, and oversight by, its board of directors, state law gives ultimate approval to the company's owners — its shareholders.

In the Omnicare case, the court determined that the combination of two provisions of a deal between NCS and another company, Genesis, effectively robbed stockholders of a meaningful vote to reject the Genesis deal in favor of a higher offer made by Omnicare.

Prospective buyers will frequently seek to negotiate deal protective terms that provide the buyer with as much assurance as possible that the deal they spend time and energy negotiating will go through. Some types of deal protection provisions have been permitted by the courts on the basis that they can be necessary to induce a prospective buyer to make an offer and undertake the time and effort to do due diligence and incur adviser and legal fees.

Unfortunately, the legal analysis in the Omnicare decision is complex, and ultimately creates significant uncertainty for companies and their advisers concerning what types of deal protective devices are permissible.

At the center of the Omnicare case was a flawed M&A process, which in part compromised shareholders' rights and led to the type of lockup arrangement that was ultimately invalidated by the court.

A prospective seller should structure the M&A process to avoid, if possible, having to agree to any type of deal protective arrangement other than a reasonable breakup fee. A breakup fee is paid by the seller to the prospective buyer if the transaction is not completed for certain reasons, most typically because of the seller's acceptance of a higher bid by a third party. While a breakup fee may to some degree deter a second bidder, who will have to make an offer sufficiently higher to cover the cost of paying the fee, the courts have generally upheld breakup fees that do not exceed 3-4 percent of the value of the transaction. The theory is that by doing so, breakup fees do not preclude competing offers and still enable the shareholders to make the ultimate decision to approve a transaction.

In a properly structured M&A process, companies should establish up front the terms on which the target is willing to negotiate and be clear with potential buyers that all protective provisions other than a reasonable break-up fee should be taken off the table.

It may also be possible to obtain an agreement from each potential buyer stating that on making an offer, they forgo the opportunity to make a subsequent offer for a specified amount of time unless invited by the company to do so.

In most instances, companies looking to sell their businesses should pursue competing offers that enable them to simultaneously evaluate all of their options. In this manner, companies can expect to negotiate the most favorable deal for shareholder approval.

Further, the process of obtaining competing offers can be done in a manner that avoids public disclosure and on a timetable established by the company.

In a well-run process, all potential bidders will have the opportunity to participate, and it is then less likely that a higher competing offer will arise following the disclosure of the proposed transaction before the shareholder vote.

While there may still be some situations that require negotiation of deal protective arrangements beyond just a breakup fee, especially when specific competitors are excluded from the process, most companies should aim to initiate an M&A process that avoids these kinds of arrangements and thereby eliminates the legal uncertainty that the Omnicare decision creates.

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