Stay on the Inside Line

Recent developments in M&A law

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Controlling Stockholder Duties Clarified

In *Synthes Inc. Shareholder Litigation*, the Delaware Chancery Court refused to impose the "entire fairness" standard of review when plaintiffs, stockholders of Synthes Inc., a Delaware corporation based in Switzerland, alleged breach of fiduciary duty based on Synthes's controlling stockholder's conflict of interest in a merger transaction. The Synthes board of directors accepted an offer to enter into a merger transaction where all of Synthes's stockholders would receive CHF (Swiss Franc) 159 per share, with 33 percent paid in cash and 65 percent paid in the acquiror's stock. In pursuing this offer, the board rejected an all-cash bid of CHF 151 per share that was conditioned on Synthes's controlling stockholder converting substantially all of his stock in Synthes into equity of the surviving company.

The plaintiffs argued that the board should not have the protection of the business judgment rule, thus subjecting the transaction to the "entire fairness" standard of review. Plaintiffs alleged that the board did not pursue the all-cash bid because the controlling stockholder was conflicted due to his financial motivation to obtain liquidity, which was adverse to the best interests of Synthes's minority stockholders. The Court, however, pointed out that "a financial interest in a transaction...does not establish a disabling conflict of interest when the transaction treats all stockholders equally."

Here, the controlling stockholder received the same treatment in the merger as all of Synthes's other stockholders. Thus, the controlling stockholder did not have a conflicting interest because he was not receiving a personal financial benefit "to the exclusion of, and detriment to, the minority stockholders." While controlling stockholders are prohibited from using their control "to exploit the minority, [they] are not required to act altruistically towards them." They do not have "a duty to engage in self-sacrifice for the benefit of minority shareholders."

Thus, a controlling stockholder's fiduciary duty to seek the best interests of the corporation and its stockholders does not mean that the controlling stockholder must accept less than the minority in order to afford the minority better terms. Rather, the Court in Synthes stated that a transaction where all of the stockholders receive equal treatment, like the Synthes merger, should be afforded the protection of the business judgment rule.

Need for Stronger Confidentiality Agreements

The recent decision by the Delaware Chancery Court in *Martin Marietta Materials Inc. v. Vulcan Materials Co.* reinforces Delaware's "procontractarian public policy" and provides a valuable analysis of language in certain confidentiality agreements. After years of attempts by Vulcan Materials Co. to engage Martin Marietta Materials Inc. in merger negotiations, the parties and longtime industry rivals entered into a confidentiality agreement amidst talk of a friendly merger. The confidentiality agreement, which did not include a standstill provision (i.e., an understanding that neither party would make an unsolicited offer for the other), provided that confidential information could be used for consideration of a "business combination transaction…between" the parties.

Market conditions changed mid-negotiation, and while Vulcan decided that a merger was no longer desirable, Martin Marietta, benefiting from the changed market conditions, began to consider alternatives to acquire Vulcan. Martin Marietta made an unsolicited exchange offer to Vulcan's stockholders, followed by a proxy contest to elect new board members at Vulcan's annual stockholders meeting.

In doing so, Martin Marietta used the confidential information that it gathered and interpreted as part of the merger negotiations to formulate its hostile bid. Further, it disclosed the confidential information to third-party advisors and publicly (under the guise of an SEC requirement that past negotiations must be disclosed in connection with an exchange offer), and argued that the disclosure did not violate the confidentiality agreement as it was "legally required." Martin Marietta argued, in part, that the confidentiality agreement permitted it to use the confidential information for the consideration of *any* "business combination transaction" between the parties, and that in conjunction with the lack of a standstill provision; it should not be enjoined from taking steps to acquire control of Vulcan shares or assets. The Court noted that phrases in the confidentiality agreement, such as a "business combination transaction…between" the parties, as well as the phrase "legally required" in connection with disclosure of certain information, were ambiguous. Nevertheless, the Court enjoined Martin Marietta from proceeding with the exchange offer and proxy contest for four months. The Court advised when drafting confidentiality agreements to do the following:

- Ensure that references to the "Transaction" refer only to the specific transaction contemplated by the parties, and that such transaction is "negotiated between" and/or "mutually agreeable to" both parties.
- Limit the permitted use of confidential information so that confidential information may not be used in any way detrimental to the disclosing party.
- State that disclosure of *any* confidential information requires prior written consent of the disclosing party, subject to customary exceptions.

Additionally, when drafting a confidentiality agreement, practitioners may wish to require that the receiving party's counsel provide to both parties, prior to disclosure of confidential information, a written legal opinion that disclosure is legally necessary, as was done in the confidentiality agreement in this case.

Not all Side Letters Are Enforceable

A ruling of the England and Wales Court of Appeal in *Georgi Velichkov Barbudev v. Eurocom Cable Management Bulgaria Eood & Ors* has raised questions regarding whether an agreement to agree (which is well-accepted as being unenforceable) is different than an agreement to negotiate in good faith. The elements of the findings of the Court of Appeal provide valuable insight for U.S. and non-U.S. entities that engage in the use of side letters to memorialize the understanding of the parties in corporate transactions.

In negotiating the merger of Eurocom Plovdiv EOOD, Mr. Barbudev and the Warburg Pincus Group executed a side letter agreeing that Barbudev would have an opportunity to invest in the merged entity on terms to be agreed to in an Investment and Shareholders Agreement which would be negotiated in good faith. The side letter provided that Barbudev invest not less than €1.65 million for shareholder debt and registered shares representing 10 percent of the registered share capital of the merged entity.

After closing, Barbudev attempted to enforce the side letter, but Warburg's counsel argued that the side letter was unenforceable because it was not intended to create legal binding relations between the parties, was an agreement to agree, and was not a sufficiently complete and certain contractual agreement. Justice Blair (of the High Court) and Justice Aikens (on appeal) determined that the side letter demonstrated the absence of an agreement by the parties, and that an agreement to negotiate in good faith is unenforceable. Justice Aikens noted that an agreement to pay "*not less than* €1.65 million" leaves an essential term uncertain and thus created no binding commitment, despite continued use of the same parameters throughout numerous transaction documents over the course of the negotiations. The legal principles applied in this English case transcend international boundaries and provide the following reminders for U.S. entities:

- The parties to a side letter must agree at which stage they desire to be legally bound. There must be a meeting of the minds regarding whether a side letter applicable to post-closing matters is meant to be enforceable or simply an unenforceable declaration of intent. Although a side letter is part of a larger transaction, it must operate as an individual agreement. If a side letter does not include complete and certain terms, it is unenforceable.
- There is a difference between creating a legal relationship and creating a legally enforceable contract. The creation of a legal relationship can be demonstrated in many ways, including language (e.g., "in consideration of you agreeing"), reference to code or governing law and incorporation of a confidentiality provision that both parties intend to enforce. In order to create a legally enforceable contract, the nature of the agreement between the parties must provide concrete terms such that essential terms are binding and not the subject of future negotiations. Language such as "not less than" [a certain investment amount] provides for the possibility that negotiations may lead to a precise figure. The context in which a side letter is agreed to will not outweigh the uncertainty of key commitments in the side letter.

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