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Delaware Court of Chancery Delays Vote on CVS/Caremark Merger

In a decision with potentially far-reaching consequences for deal structuring, the Delaware Court of Chancery issued a preliminary injunction postponing for at least 20 days a vote of the stockholders of Caremark RX, Inc. on its proposed merger with CVS Corporation. *Louisiana Municipal Police Employees' Retirement System v. Crawford*, C.A. Nos. 2635-N, 2663-N (Del. Ch. Feb. 23, 2007). Although the mere postponement of the vote appears to be unremarkable, the Court's decision merits attention because of the primary reason for the injunction – the Court treated a special dividend and a stock for stock merger as an integrated transaction and concluded that the Caremark stockholders were entitled to appraisal rights.

The Court's ruling is a surprise to many practitioners and seems contrary to the well-settled Delaware corporate law doctrine of independent legal significance. Absent the special dividend, which would be declared by the Caremark board prior to the merger, the Caremark stockholders would not have been entitled to appraisal rights as a result of the stock for stock merger because of the "market out" exceptions of the appraisal statute, Section 262. In reaching the decision that the special dividend was effectively cash consideration to be paid to the Caremark stockholders as part of the proposed merger with CVS, the Court was persuaded by the fact that the payment of the special dividend was specifically conditioned on stockholder approval of the merger agreement and only became due after the effective time of the merger. The Court concluded that those "facts belie the claim that the special dividend has legal significance independent of the merger" and thus "the label 'special dividend' is simply cash consideration dressed up in a none-too-convincing disguise."

Although the Court's decision on the availability of appraisal rights is startling to some practitioners, it may be explained to some extent by the Court's apparent skepticism about the Caremark board's decision to continue to recommend the CVS/Caremark merger, despite the existence of a competing offer by Express Scripts, Inc. In particular, the Court stated that the Caremark stockholders "should not be denied their appraisal rights simply because their directors are willing to collude with a favored bidder to 'launder' a cash payment." Indeed, the Court found that it was CVS, not Caremark, that initially proposed the dividend in response to the Express Scripts offer. In the end, the Court determined to postpone, and did not indefinitely enjoin, the vote, finding that there was neither irreparable harm nor extraordinary inequity because the stockholders would have the opportunity to vote in a fully-informed manner on the CVS/Caremark merger, supported by the protection of the appraisal remedy.

The Court's skepticism about the Caremark board process is evidenced by its discussion of the personal benefits to be received by Caremark's officers and directors as a result of the CVS/Caremark merger. Those benefits included (i) cash payments payable to many of the directors and officers pursuant to certain change of control provisions in their employment agreements (even though the Caremark board insisted that the transaction did not constitute a "change of control" for purposes of *Revlon*), and (ii) structural and contractual protections from the liability that could

result from the Caremark option backdating scandal. The Court noted that it was not clear that a third party bidder would offer those same benefits in a superior proposal.

The Court found the contractual liability protections to be particularly troubling. The surviving company agreed not only to contractually honor any grant of options by Caremark, but also, and most significantly, to indemnify all past and present directors of Caremark "to the fullest extent permitted by law." The Court found the indemnity agreement to be powerful because it provided the Caremark board, and particularly the independent directors, with indemnification rights that Caremark itself might not have been able to provide the directors – because the directors could be liable to Caremark under the reasoning of the recent *Tyson Foods* decision, which finds that directors risk potential personal liability for manipulating the grant date of options, even if they did not personally benefit from the manipulation. Therefore, the Caremark board was able to obtain indemnity protection from a third party – CVS – in the event that they were found to be liable in the backdating scandal.

As for deal protections, the Court again emphasized, as it did in *Toys "R" Us*, the context specific analysis required to determine the reasonableness of deal protections. Most interestingly, the Court rejected, with some emphasis, the contention that the Court should accept certain deal protections as *per se* reasonable simply because they are customary. In that regard, the Court refused to find that a 3% termination fee was *per se* valid, instead noting that the Court will consider a number of factors in determining the reasonableness of the fee, including "the overall size of the termination fee, as well as its percentage value; the benefit to the shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole."

The Court also found that a postponement of the stockholder vote was necessary to provide the Caremark stockholders with additional disclosure relating to the contingent nature of the financial advisors' fee. That disclosure was misleading because it did not clearly state that the financial advisors were entitled to the fee only if the initial CVS/Caremark merger was approved. The Court concluded that knowledge of such financial incentives on the part of the financial advisors was material to the stockholder deliberations.

The *Caremark* decision could have important implications for deal structuring. The Court's treatment of the special dividend and the merger as an integrated transaction, notwithstanding the doctrine of independent legal significance, may lead practitioners to become more concerned that a Delaware court may focus on the substance, rather than the form, of corporate transactions. In our view, the decision should be read narrowly, however, as applicable to the unique facts of the case, including the fact that (i) the special dividend was viewed by the Court as a mechanism by which the directors were colluding with a bidder to favor a deal that arguably benefited the directors personally, and (ii) the availability of the appraisal remedy permitted the Court to merely postpone, and not completely enjoin, the vote. The decision also indicates that the Court remains focused on the contingent nature of financial advisor fees and strongly suggests that practitioners should remain vigilant when negotiating those fees in order to ensure that financial advisors are properly incentivized to advise a board or a committee thereof.