March 23, 2007

In re Caremark – The Takeover Chronicles

A lot happened at Caremark after the seminal 1996 decision of the Delaware Court of Chancery addressing the duties of directors in the context of a significant compliance failure. A new Board and management team took the helm and achieved spectacular results, delivering cumulative shareholder returns of over 1300% in the eight year period between November 1998 and November 2006 and over 1600% when measured from November 1998 through March 21, 2007, the day before Caremark's recent merger with CVS closed.

Despite the Caremark team's exceedingly strong record of serving shareholder interests, many shareholders and market commentators were skeptical at first when Caremark announced its transformational merger-of-equals transaction with CVS on November 1, 2006. Caremark shares, which had closed at $49.23 per share on October 31, 2006, the date before the announcement, traded down to as low as $44.30 on November 28, 2006, as market leaks regarding the transaction impaired the ability of CVS and Caremark to convince investors of the strong strategic rationale for the deal in the early days following its announcement. And, in the wake of Express Scripts' emergence as a competing bidder for Caremark, some commentators accused Caremark's Board of conducting a "flawed process," despite the fact that the Board's actions yielded spectacular results for the Caremark shareholders, including an enhancement in the value of the CVS deal through the addition of a $3.2 billion special cash dividend.

The story of the CVS/Caremark/Express Scripts battle can be summarized as follows: In response to the weak initial market response to the CVS/Caremark merger announcement—which called for Caremark shareholders to receive 1.67 shares of CVS stock for each Caremark share—Express Scripts, a competitor less than half Caremark's size, launched an aggressive part-cash, part-stock counter offer for Caremark on December 18, 2006. Express Scripts' apparent objectives included derailing the CVS/Caremark merger and, given the highly conditional terms of its offer, obtaining what might well be described as an option on a possible combination with Caremark. Despite the highly conditional nature of Express Scripts' bid, the market embraced the competitive battle, pushing the shares of both Express Scripts and Caremark higher in anticipation of a bidding war. Nevertheless, both CVS and Caremark remained firmly committed to their strategic combination and waged an aggressive campaign to gain shareholder support for the CVS deal. Realizing that a strong competitive response from CVS would be necessary to counter the market's embrace of Express Scripts' offer, Caremark negotiated with CVS to increase its offer on three separate occasions, ultimately obtaining CVS's approval of a special cash dividend of $7.50 per share to Caremark shareholders and a commitment by CVS to tender for 10% of the combined company's stock at $35 a share after the deal closed. In the end, the shareholders of CVS and Caremark both won out strongly, with CVS shares closing at $34.67 and Caremark shares closing at $65.23 the day before the merger was completed (well above their respective trading prices on the day before the CVS/Caremark merger was first announced, and in Caremark's case at an impressive 32.5% premium to its pre-announcement trading level).

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While the story line of the CVS/Caremark/Express Scripts battle is fairly simple, the lessons from the battle are somewhat more complex and offer important insights into several significant developing trends in the current M&A and corporate governance landscape:

We Are Living in Cynical Times and Actions By Corporate Boards and Managers Are Being Viewed With Deep Skepticism, No Matter How Strong their Past Track Records or the Merits of their Present Actions. The Caremark Board met numerous times to consider the merits of the strategic combination with CVS and played an extremely active role in guiding management's conduct of the initial merger discussions, obtaining the subsequent increases in merger value and in reviewing and responding to the Express Scripts bid. Despite making exceedingly sound judgments with respect to the creation of billions of dollars in shareholder value both before the merger was first announced and in response to the interloping bid by Express Scripts, the Board's and management's actions were subject to various criticisms by activist shareholder constituencies, the popular press and shareholder advisory services. Oftentimes, the truth regarding the deliberations and process mattered little, as various constituencies spun the facts to fit their desired perceptions. To the Caremark Board's credit, it stayed above the fray and remained steadfastly determined not to compromise its fiduciary obligations in an effort to stave off these baseless criticisms.

It is Critical to Get Ahead of the Curve in Selling a Deal; Pre-Announcement Leaks Can Be Deadly On This and Other Fronts. CVS and Caremark fell behind the curve in selling the merits of their strategic business combination when news of the deal leaked before announcement. It took several weeks to recover from the initial roll-out, and during this time Caremark remained vulnerably exposed, thus whetting Express Scripts' appetite for the attack.

There is No Cookie Cutter Formula for Responding to an Interloping Bid; Sometimes the Harder Road is the Better One. It would have been much easier for the Caremark Board to open the company's books to Express Scripts than to face the storm of criticism fueled by Express Scripts' aggressive media campaign and other market pressures. But the Board reached the judgment that doing so was not in the best interests of Caremark's shareholders, and by sticking to its convictions the Board served their shareholders' interests very well. The Caremark Board ultimately delivered a deal worth over $65 per share as of close of market on March 21, 2007, the day before the CVS merger was consummated, while at the same time protecting shareholders against the risks of Express Scripts' highly conditional bid, including the potential loss of existing and prospective customers who had voiced opposition to a combination with Express Scripts. The Board also used the leverage of the Express Scripts' bid to sweeten the terms of the original CVS transaction, negotiating with CVS to add a $7.50 special cash dividend for the Caremark shareholders and a $35 per share post-closing tender offer open to shareholders of the combined company, while still preserving all of the strategic and financial benefits associated with the original merger-of-equals transaction. It is far from clear that CVS would have been willing to agree to these material improvements in the initial deal terms had Caremark engaged Express Scripts in merger discussions. Even though the Caremark Board was chastised for failing to negotiate with Express Scripts, the Board's actions ultimately gave rise to substantial enhancements to the value of the consideration received by Caremark's shareholders.

While Subjecting the Transaction to Careful Scrutiny, the Delaware Court of Chancery Ultimately Allowed the Merger to Proceed to a Shareholder Vote. The Delaware Court of Chancery kept the Caremark Board's feet to the fire, as it twice delayed the Caremark shareholders meeting to consider the CVS merger in order to, in the Court's words, give the shareholders "time to receive, absorb, and decide upon new information" that Caremark disclosed to them after the initial proxy statement was sent out. Notably, these delays pushed the meeting date from February 20, 2007 to March 16, 2007 and gave all concerned time to see whether the FTC would issue a "second request" to Express Scripts (the FTC had already cleared the CVS merger) or whether Express Scripts instead would obtain quick antitrust clearance of its bid, as it had maintained it would. (Express Scripts ultimately did receive a second request). While the Court of Chancery closely scrutinized the conduct of the Caremark Board and management in its initial February 23, 2007 opinion, the Court declined to enjoin the CVS merger, concluding that the "balance of the equities weighs in favor of permitting informed shareholders" to vote. And, in a subsequent oral ruling denying Express Scripts' application for leave to appeal, the Court of Chancery noted that it "has not found that any of the Caremark directors have violated any of their fiduciary duties." In the end, the Court refused either to overturn standard merger agreement provisions—including a "no shop" provision and a 3% termination fee—or to force Caremark to negotiate with Express Scripts, while cautioning that the validity of such provisions turns on the circumstances of each case.

Executive Compensation Remains a Hot Button, No Matter What the Underlying Facts. Executive compensation issues and options granting practices played a key role in the Caremark/Express Scripts battle. Caremark had previously announced its receipt of government inquiries concerning its options granting practices and, despite issuing strong denials that management or the Board had engaged in any improper options granting practices, the mere pendency of these inquiries plagued Caremark throughout the takeover battle.

Not All Change-of-Control Definitions Are Created Equally. Another compensation issue that received critical attention from the Court of Chancery and other quarters was the change-of-control provisions in Caremark's employment arrangements with senior management. It is very common for a transaction such as the CVS/Caremark deal to trigger change-of-control acceleration rights in stock-based plans and change-of-control severance rights under so-called golden parachute contracts, even though the transaction is not considered a "change of control" within the meaning of the Delaware *Revlon* doctrine. None of the Caremark employees who were being offered continuing jobs with the combined company were to receive change-of-control payments on the closing of the transaction; instead these payments were to be rolled into retention bonuses designed to ensure that these employees would stay on. While the Court of Chancery noted the tension in treating the CVS merger as a change-of-control for employment purposes, but not for corporate law purposes, the Court's analogy to Lewis Carroll's Humpty Dumpty in *Through the Looking Glass*—"[w]hen I use a word . . . it means just what I choose it to mean"—was more rhetorical than doctrinal. It has long been established under Delaware law that a 100% stock-for-stock merger transaction does *not* constitute a change of control for *Revlon* purposes. We do not read the Court's Humpty Dumpty footnote to portend any change to this bedrock principle of Delaware law particularly where, as here, the transaction

involved stock-for-stock consideration, evenly split board representation and the Caremark shareholders owning a substantial percentage of the combined company.

"Independent Legal Significance" Is Not So Certain in Delaware, At Least Not in the Court of Chancery. One aspect of the rulings in the Caremark battle did take many corporate practitioners by surprise—the determination by the Court of Chancery that Caremark shareholders were entitled to appraisal rights based on the special dividend that was declared by the Caremark Board (with the permission of CVS) to be paid conditioned on the closing of the merger. Appraisal rights are triggered under Section 262(b)(2) of the Delaware General Corporation Law when shareholders are "required by the terms of the [merger agreement] . . . to accept for" their stock anything except shares of stock or cash in lieu of fractional shares. Caremark's merger agreement with CVS did not require Caremark's shareholders to accept anything other than shares of CVS stock "for" their Caremark shares. The special cash dividend declared by Caremark's Board, though conditioned on the shareholders' approval of the merger, was a separate transaction from the merger itself. Delaware courts have traditionally applied a doctrine of independent legal significance, and therefore a dividend declared prior to the consummation of a merger (even if conditioned upon consummation of the merger) had previously been thought by most practitioners to constitute consideration separate and apart from the merger consideration. The Court of Chancery, however, determined that since the special dividend became payable upon or after the closing of the CVS merger and was conditioned upon shareholder approval of the merger agreement, Caremark's shareholders were entitled to appraisal rights. It remains to be seen whether this ruling will be extended to other transactions involving different underlying facts.

Getting to the End-Game in a Bidding Contest Requires a Careful Balancing of Tactics, Disclosures and Technical State Law, NYSE and SEC Legal Requirements. Caremark and CVS adopted a special dividend structure in order to avoid the delay that might otherwise have resulted from modifying the merger agreement to provide that a combination of cash and CVS stock would be exchanged for Caremark stock. While recognizing that enhancements to the deal terms offered by CVS would likely be needed to obtain shareholder approval of the CVS/Caremark merger, Caremark recognized the tactical imperative of conducting a prompt shareholder vote on the transaction, since continued delay ran a high risk of exposing the Caremark business to significant customer attrition during the company's important selling season. Proximity to an expected meeting date was also important to motivate CVS to enhance its offer (rather than wait out the storm). Navigating the landscape of Delaware legal notice and equitable disclosure requirements, and NYSE and SEC notice and disclosure rules, required careful consideration and planning.

A Dollar Dividend Bump is a Dollar Dividend Bump. As noted, the special dividend resulted in a total of approximately $3.2 billion in additional consideration being paid to Caremark shareholders. Express Scripts and others argued that each dollar of cash dividend was not really a full dollar bump since Caremark shareholders would own approximately 45.5% of the total outstanding shares of CVS after the merger and thus would be paying 45.5 cents of each dollar dividend to themselves. This analysis misses the point that, at the end of the day, Caremark shareholders got $7.50 in cash (indisputably worth $7.50) and 1.67 shares of CVS

stock for each Caremark share. As of the close of the transaction, this combination of cash and stock was worth in excess of $65 per share.

A Bid in Hand is Still Worth More Than A Bid in the Bush. It is often the case that boards and shareholders are asked to make difficult qualitative judgments about the value of a bid in hand versus a more conditional bid that may be available at some future date. One of the reasons that the Delaware courts have generally refused to substitute their judgments for those of corporate boards in these instances is the recognition that such decisions are not always easy or clear. In the heat of a takeover battle, shareholders have an incentive in the short term to value a contingent bid more highly than it might otherwise be worth since they want to promote an active bidding contest. And, in a three-way bidding contest such as the one involving CVS, Caremark, and Express Scripts, technical arbitrage pressures can often distort the true underlying values of the competing bids. The Caremark Board never lost sight of the value inherent in the strong CVS bid in hand. Ultimately, Caremark shareholders came to recognize that value as well.

The Importance of ISS. Finally, the Caremark merger once again demonstrates the important role that Institutional Shareholder Services (ISS) and other proxy voting and corporate governance advisory services can play in a contested merger contest. In Caremark's case, absent a favorable recommendation from ISS with respect to the final revised CVS proposal, it is not clear whether Caremark would have been able to obtain a favorable shareholder vote on the CVS merger. ISS was an important consideration in all tactical steps taken by CVS and Caremark and, even when the initial ISS recommendation was issued against the initial CVS/Caremark proposal, Caremark and CVS continued to work aggressively in an effort to win ISS's final recommendation as well as the approval of other important shareholder constituencies.

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