spin subsidiary or its present or future creditors.[22] Because VFI was solvent at the time of the spin-off, Campbell's pre-spin directors owed no fiduciary duties to VFI's creditors, and the litigation LLC's claim against Campbell for aiding and abetting breach of fiduciary duty failed.[23]

The Third Circuit's valuation analysis in *VFB* should prove equally applicable not only to spin-off transactions in particular, but to judicial valuations of similar types of leveraged public company transactions. However, the *VFB* case may have important near-term implications for at least two other pending lawsuits challenging spin-off transactions on fraudulent transfer and breach of fiduciary duty grounds.[24] In both cases, as in *VFB*, creditors of failed spun-off subsidiaries—satellite telephone manufacturer Iridium LLC, and energy trading concern Mirant Corporation—have asserted fraudulent transfer and fiduciary breach claims against their former parent corporations, respectively Motorola, Inc. and The Southern Company.

In the *Motorola* case, a recent trial phase devoted to the solvency inquiry, which presently awaits decision by the United States Bankruptcy Court for the Southern District of New York, featured extensive debate over the reliability of contemporaneous market-based valuation evidence, as well as competing testimony by expert valuation witnesses. And while the *Southern Company* case remains in its discovery phase, the pleadings filed by the parties indicate that the plaintiff will need to overcome significant market-based valuation evidence in order to prevail on fraudulent transfer or breach of fiduciary duty grounds.

The *Motorola* and *Southern Company* lawsuits, as well as other future judicial challenges to public company transactions on valuation-based grounds, provide additional opportunities for courts to follow the Third Circuit's valuation approach in *VFB*, thus enhancing protection and certainty for corporations and their managers and directors in evaluating and effectuating leveraged corporate transactions that are supported by informed contemporaneous market-based evidence of value.

NOTES

1. 482 F.3d 624 (3d Cir. 2007).
2. *Id.* at 628.
3. 2005 WL 2234606 (D. Del. Sept. 13, 2005).
4. *Id.* at *23.
5. 482 F.3d at 631.
6. *Id.*
7. *In re R.M.L., Inc.*, 92 F.3d 139, 155 (3d Cir. 1996).
8. 482 F.3d at 633.
9. *Id.* at 629.
10. *Id.* at 633.
11. 2005 WL 2234606.
12. 482 F.3d at 634.
13. 128 Fed. Appx. 839, 848 (3d Cir. 2005).
14. *Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826, 835 (7th Cir. 1985).
15. *Peltz v. Hatten*, 279 B.R. 710, 738 (D. Del. 2002), *aff'd mem.*, 60 F. Appx. 401 (3d Cir. 2003).
16. 85 F.3d 314, 320 (7th Cir. 1996).
17. 914 F.2d 458, 475 (4th Cir. 1990).
18. *Peltz*, 279 B.R. at 738; *see also Metlyn*, 763 F.2d at 836 ("The process of valuation by testimony may obscure rather than illuminate the value under study, while market processes overcome personal biases, quirks and errors.").
19. *Metlyn*, 763 F.2d at 835.
20. *Peltz*, 279 B.R. at 742.
21. 482 F.3d at 633.
22. 545 A.2d 1171 (Del. 1988).
23. 482 F.3d at 634-36.
24. *Statutory Committee of Unsecured Creditors v. Motorola, Inc.*, No. 01-02952 (Bankr. S.D.N.Y.); *MC Asset Recovery, LLC v. The Southern Co.*, No. 06-00417 (N.D. Ga.).

Judicial Scrutiny of Deal Protection Measures

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Recent Delaware decisions have put deal protection measures back in the spotlight. In *Louisiana Municipal Police Employees' Retirement System v. Crawford*, for example, the Delaware Court of Chancery was sharply critical of the deal protections in a merger agreement between CVS Corporation and Caremark

RX, Inc.[1] Although many of the deal protections in *Crawford*—including a 3% termination fee—might be viewed as common, the court made clear that there are no bright-line rules in determining their coercive and preclusive effects. Subsequent decisions, however, upheld the validity of higher termination fees that were coupled with matching rights. Read together, these decisions emphasize the context-specific analysis of deal protections and are a poignant reminder that practitioners must be able to articulate to their clients the various justifications for deal protections in specific circumstances.

The Caremark-CVS Merger Agreement

Crawford involved a "merger-of-equals" between CVS and Caremark. The merger agreement contained a force-the-vote provision requiring each company to hold a stockholder vote. The merger agreement also contained reciprocal no-shop provisions that prohibited solicitation of third-party proposals, subject to a customary fiduciary out allowing either board to respond to an "unsolicited bona fide written Acquisition Proposal" that it "determined in good faith (after consultation with its outside legal counsel and financial advisors) constitutes or is reasonably likely to lead to a Superior Proposal."[2] Before accepting a superior proposal, the company had to comply with a five-day matching rights or last-look provision.[3] The merger agreement also contained reciprocal termination fees of $675 million, or 3% of Caremark's equity value and, given Caremark's negligible debt, essentially the same percentage of enterprise value. The termination fees were payable upon a change in board recommendation or a no-vote by the stockholders followed by another transaction within twelve months.

The *Crawford* Decision

After the CVS-Caremark merger was announced, Express Scripts, Inc. made an unsolicited offer to acquire Caremark and litigation ensued. In temporarily enjoining the Caremark stockholders meeting until certain supplemental disclosures were made,[4] Chancellor William B. Chandler III made some critical observations of the deal protections in the merger agreement. In particular, he referred to the no-shop provisions as a "road map by which a competing bidder may tiptoe around termination fee landmines in order to make a hostile offer."[5] He also referred to the 3% termination fee as the "foundation" of the "intricate barricade" of deal protection provisions in the agreement.

The court unequivocally rejected Caremark's argument that a 3% termination fee was reasonable *per se*. This was so despite prior Delaware decisions characterizing 3% termination fees as "traditional" and "modest and reasonable."[6] Indeed, in *McMillan v. Intercargo Corp.* the Court of Chancery referred to a 3.5% termination fee as an "insubstantial obstacle" and noted that it was "difficult to see how a 3.5% fee would have deterred a rival bidder."[7] Nevertheless, *Crawford* made clear that any attempt to "build a bright line rule" would be done "upon treacherous foundations."[8] Chancellor Chandler continued that, "[t]hough a '3% rule' for termination fees might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule."[9] Although its sharp tone may have been influenced by alleged process flaws and Caremark's decision not to negotiate with Express Scripts, the court nevertheless went out of its way to comment on the deal protections and its dicta must be taken seriously.

Subsequent Delaware Decisions

Since *Crawford*, the Court of Chancery has issued three other decisions relevant to deal protection measures, each written by Vice Chancellor Leo E. Strine, Jr. The first was *In re Netsmart Technologies, Inc.*, which involved the auction of a small-cap company to private-equity buyers. Although the court concluded that the auction process was flawed, it observed that a 3% termination fee based on equity value was "not unreasonable, especially given the size of the transaction and the fact that upon triggering more than a third of the fee would simply go to repay Insight's actual expenses."[10] According to the defendants, the termination fee was equal to $0.43 per share on a fully-diluted basis. It also bears noting that the merger agreement did not contain matching rights.

The second, *In re The Topps Company Shareholders Litigation*, addressed a termination fee and matching rights in a merger agreement that contained a go-shop clause. The *Topps* fee represented

4.3%–4.6% of equity value, including expenses. Vice Chancellor Strine observed that a matching right was "a useful deal protection for [a buyer], but one that has frequently been overcome in other real-world situations."[11] He then continued that, while a 4.3% termination fee was "a bit high in percentage terms, it includes [the buyer's] expenses, and therefore can be explained by the relatively small size of the deal. At 42 cents a share, the termination fee (including expenses) is not of the magnitude that I believe was likely to have deterred a [rival] bidder...."[12] At least in the context of a go-shop provision, the *Topps* combination of deal protections still "left reasonable room for an effective post-signing market check."[13] Important to the court's analysis, however, was the fact that the topping bidder, Upper Deck, did not stress the termination fee in requesting an injunction from the court.

Finally, the Court of Chancery upheld a termination fee equal to 3.5% of equity value and a ten-day matching right that were combined with a 45-day go-shop period in *In re Lear Corporation Shareholders Litigation*.[14] The termination fee, including maximum out-of-pocket expenses, was equal to 2.4% of Lear's $4.1 billion enterprise value, which included $2.5 billion of debt. Vice Chancellor Strine then offered insight into an issue that practitioners have long debated: whether termination fees should be judged based on equity or enterprise value. Vice Chancellor Strine observed that in assessing a termination fee's preclusive effect:

> **it is arguably more important to look at the enterprise value metric because, as is the case with Lear, most acquisitions require the buyer to pay for the company's equity and refinance all of its debt.**[15]

The court then held that the termination fee was "hardly of the magnitude that should deter a serious rival bid."[16] The court also observed that the matching right—a "hardly novel" concept—provided for a single last-look right if a topping bid exceeded the merger consideration by $1.00 per share, thus giving an incentive to third parties to materially outbid the initial buyer.[17]

Revisiting the Justifications for Deal Protection Measures

Crawford stands as a conscious reminder from the Delaware courts that deal protection measurers must be assessed in a context-specific manner. Although Delaware courts have consistently recognized the utility of deal protections, there is no customary combination or bright-line rule that will always carry the day. Under *Revlon*, deal protections are permissible so long as the board acted reasonably in obtaining the best value for stockholders. But even outside *Revlon*, deal protection measures are subject to *Unocal* review as defensive measures. Delaware courts therefore will still examine "the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole."[18]

This string of recent Delaware decisions is a reminder of the various justifications used for deal protections. *Crawford* specifically stated that the court's analysis includes:

- the overall dollar-size of the termination fee, perhaps suggesting that even a low-percentage fee might be impermissible due to its sheer size;
- the size of the termination fee in percentage terms (equity and enterprise);
- the size of the termination fee relative to the benefit to shareholders, including the size of any premium being offered;
- the absolute size of the transaction, as well as the relative size of the partners to the merger; and
- the degree to which a counter party found the deal protections to be crucial to the deal, bearing in mind differences in bargaining power.[19]

Other factors traditionally have included the initial buyer's opportunity costs as well as any reputational loss resulting from a successful topping bid. Delaware courts also are mindful of give-and-take during negotiations: a higher termination fee may be justified, for example, in return for a broader post-signing market check or an increase in the purchase price.

Topps and *Lear* also suggest that the board's market-check activities can influence the appropriateness of deal protections. While *Crawford* was critical of a 3% termination fee in a strategic merger-of-equals that was concluded without any pre-signing market check or post-signing go-shop period, *Topps* and *Lear* approved significantly higher fees (4.3% and

3.5%, respectively) in conjunction with deals that were subject to go-shop provisions.[20] At the same time, practitioners must be sure that the deal protections do not impede the utility of post-signing market checks.

Vice Chancellor Strine's comment in *Lear* on the use of enterprise value versus equity value indicates that practitioners and directors should evaluate termination fees using both metrics. As Vice Chancellor Strine notes, the size of the fee as a percentage of enterprise value should be considered in evaluating the fee's preclusive effects under *Unocal*, which tests whether a competing bidder could top the deal as a whole. Using enterprise value is generally appropriate in this context if the acquirer must assume the target's debt, pay it off, or otherwise refinance it. The size of the fee therefore must be judged in light of the overall transaction cost to the acquirer, not just in terms of equity value.

A *Unocal* analysis also looks to whether the termination fee is "coercive," which considers the impact of the fee on the stockholders' ability to vote down the deal. Although not discussed by Vice Chancellor Strine, equity value is likely the correct measure for this analysis, because the question from the stockholders' standpoint is "what value will the equity have if I vote down this deal." The answer to this question is only affected by the value of the equity, not the value of its debt. Because *Unocal* involves both a preclusiveness and a coerciveness analysis, practitioners and directors should examine both issues.

The final step in the *Unocal* analysis is whether the fee falls within a "range of reasonableness." There is not yet any guidance on which measure should be used to judge "reasonableness," so the prudent course is to consider both enterprise and equity value, including maximum expenses payable to the buyer.

Enterprise as opposed to equity value also seems like the correct measure if a termination fee is structured as a liquidated damages provision. Practitioners have the flexibility to structure a termination fee in this manner, in which case the fee is not reviewed under *Unocal* but rather is examined to determine whether the amount is either "unconscionable" or "not rationally related to any measure of damages a party might conceivably sustain."[21] A low percentage fee is unlikely to be "unconscionable," so the question instead will be whether the amount is "rationally related" to a damages measure. From the acquirer's perspective, the loss of a target is best represented by the enterprise value of the target as a whole, not merely its equity value. It follows that enterprise value is the more appropriate measure for a liquidated damages analysis.

Crawford and subsequent decisions can be squared only by looking to the fact-dependent judicial analysis of deal protections. M&A practitioners must be prepared to articulate to their clients why various combinations of deal protection measures are being employed. In *Netsmart*, Vice Chancellor Strine warned that various M&A techniques cannot be applied in rote fashion and, instead, have to be justified based on the circumstances. This is consistent with *Crawford*, where Chancellor Chandler cautioned against any presumptions of reasonableness. In the current market, one consequence is that practitioners must consider whether traditional deal protection justifications are readily applicable to, for example, financial buyers. More generally, practitioners must determine what combination of deal protections—including matching rights, force-the-vote provisions, no-shops, and termination fee and expense reimbursements—is appropriate in light of a target's pre-signing market check and its ability to conduct a post-signing market check through a fiduciary out or a go-shop provision.

NOTES

1. La. Mun. Police Employees' Ret. Sys. v. Crawford, C.A. Nos. 2663 & 2635, 2007 WL 582510 (Del. Ch. Feb. 23, 2007).
2. Agreement and Plan of Merger, dated as of Nov. 1, 2006, among CVS Corp., Caremark RX, Inc. and Twin MergerSub Corp., at § 8.07(b). A "Superior Proposal" was defined as a written proposal for at least a majority of either company's common stock that was determined to be more favorable "from a financial point of view" to the stockholders and for which financing was "fully committed or reasonably determined to be available." *Id.* § 8.07(f).
3. *Id.* § 8.07(d).
4. *See generally* J. Travis Laster & Steven M. Haas, *Caremark Stockholders Meeting Temporarily Enjoined Over Disclosures*, Wall Street Lawyer, Apr. 2007, at 9 (discussing the disclosure rulings in *Crawford*).

5. *Crawford*, 2007 WL 582510, at *4.
6. *In re* Pennaco Energy, Inc., 787 A.2d 691, 702, 707 (Del. Ch. 2001).
7. McMillan v. Intercargo Corp., 768 A.2d 492, 505–06 (Del. Ch. 2000).
8. *Crawford*, 2007 WL 582510, at *4 n.10.
9. *Id.*
10. *In re* Netsmart Techns., Inc., C.A. No. 2563, 2007 WL 926213, at *29 (Del. Ch. Mar. 14, 2007).
11. *In re* Topps Co. S'holders Litig., C.A. Nos. 2786 & 2998, 2007 WL 1732586, at *25 (Del. Ch. June 14, 2007).
12. *Id.*
13. *Id.* at *26.
14. *In re* Lear Corp. S'holder Litig., C.A. No. 2728, 2007 WL 1732588 (Del. Ch. June 15, 2007).
15. *Id.* at *24.
16. *Id.*