JONES DAY

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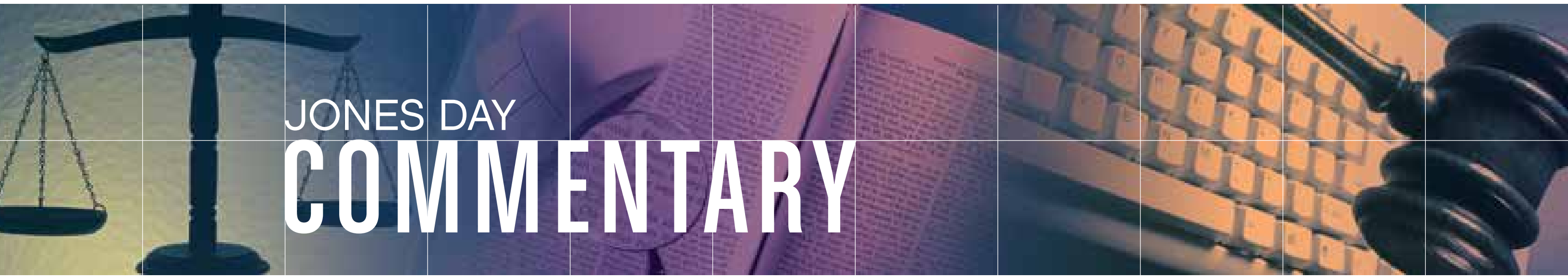

DON'T ASK, DON'T WAIVE STANDSTILL PROVISIONS: A TOOL TO MAXIMIZE VALUE OR WILLFUL BLINDNESS?

Two recent bench rulings by respected Delaware Chancery Court judges—*In re: Complete Genomics, Inc. Shareholder Litigation*[1] (Vice-Chancellor Laster) and *In re: Ancestry.com Inc. Shareholder Litigation*[2] (Chancellor Strine)—questioned and, in one case, enjoined the enforcement of so-called "don't ask, don't waive" standstill provisions in deal process confidentiality agreements. Although we do not believe that these provisions are now *per se* unenforceable in Delaware, target companies will need to employ these provisions with care to ensure that they survive judicial scrutiny.

A PRIMER ON THE JARGON

Deal professionals love jargon, and this area has plenty of it:

- A potential acquirer that is bound by a "standstill" is typically obligated to refrain from various actions that relate to acquisition of control of the target, such as making proposals to acquire the target, buying shares, and launching a proxy contest.
- A "don't ask, don't waive" provision in a standstill prohibits a potential acquirer from making any public or private request that a target waive the standstill restrictions.
- Merger agreements entered into after a strategic process usually have "no shop" or "no talk" provisions that prohibit a target from sharing confidential information with or discussing a potential competing acquisition with potential acquirers.
- However, merger agreements also typically include "fiduciary out" clauses, which permit the target to communicate with a potential interloping bidder that makes an unsolicited superior proposal.

1 C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012) (transcript).
2 C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012) (transcript).

THE UTILITY OF "DON'T ASK, DON'T WAIVE" PROVISIONS

In Delaware and some other states, in certain circumstances company sales processes are characterized as auctions—processes designed to produce the highest short-term value reasonably available to stockholders.[3] Auctioneers of rare art or other items say "going, going…" and pause before saying "gone" for a reason—to induce the best bid. But they never let bidders hold back and rebid after the gavel comes down for good reason. Before *Genomics*, most deal practitioners believed that the same thinking applied to company sale processes.

The rationale behind "don't ask, don't waive" provisions is the same—once a bidder has been invited into the process to make an offer and has been given access to confidential information, the target board wants to incentivize bidders to make their best and final proposals as to price and terms. Consider the following fairly typical hypothetical:

- Acquirer A and Acquirer B are active participants in a consolidating industry. Both Acquirer A and Acquirer B have ample financial resources. While the target's investment banker sends out dozens of feelers, these two are commonly understood to be the most likely bidders.
- In order to allow the target to control its own sale process and force Acquirer A and Acquirer B to play within a board-supervised sale process, the target includes a standstill in its confidentiality agreement with all bidders, which provides that the bidders are precluded from making an unsolicited public bid for the target. The confidentiality agreement does not, however, include a "don't ask, don't waive" provision.
- Acquirer A values the target at $12 per share, and Acquirer B, which has significantly more synergies with the target and a lower cost of capital than Acquirer A, values the target at up to $20 per share. Acquirer B senses that it can pay a lot more than Acquirer A, but it is not sure by how much; Acquirer B's best guess is that Acquirer A would pay in the neighborhood of $14–16 per share.
- Acquirer B knows it can rebid and has only the break-up fee at risk, which is not a lot here because of case law and practice that generally limits break-up fees to 3–5 percent of deal value. So, instead of making its best offer, Acquirer B submits a lowball offer for $10 per share and waits to see if and at what price Acquirer A offers. The target enters into a definitive agreement with Acquirer A for $12 per share. The merger agreement includes a fiduciary out and corresponding termination right, with a 3 percent break-up fee, translating to roughly $0.50/share.
- After the merger is announced, Acquirer B comes back and asks the target to waive its standstill and includes a very light mark-up of Acquirer A's merger agreement, a $13.50/share price, and a commitment to pay the break-up fee.

What do the fiduciary duties of the target's directors require in this context? Can they maintain their recommendation in favor of the transaction with Acquirer A? Established case law suggests that it would be difficult for the target to maintain its recommendation of Acquirer A's bid without disclosing Acquirer B's higher bid, even though it was submitted after the merger agreement was signed.[4] Given this, and the board's desire (and obligation) to get the best price reasonably available anyway, Acquirer B wins at $13.50/share, plus the break-up fee, an amount higher than Acquirer A's bid but still less than what Acquirer B would have bid had it not had another bite at the apple.

THE BENCH RULINGS

The Chancery Court's rulings in *Genomics* and *Ancestry.com* were so-called bench rulings—oral rulings issued from the bench. Bench rulings do not have binding precedential effect but are suggestive of how the Chancery Court views certain issues put before it. As Chancellor Strine noted in *Ancestry.com*, "[b]ench rulings are limited rulings. They're

3 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 183-84 (Del. 1986).
4 *See*, e.g., *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270, 1280-81 (Del. 1994) (pre-agreement indications).

time-pressured ones ... and because they're time-pressured, they shouldn't make broad law."[5]

Genomics. In *Genomics*, Vice Chancellor Laster enjoined Complete Genomics, Inc. from enforcing a "don't ask, don't waive" provision in a confidentiality agreement with a bidder in connection with its merger with BGI-Shenzhen.[6]

Genomics entered 2012 in financial distress. It had minimal cash and had received a going concern qualification on its most recent year-end audited financial statements. In June 2012, it publicly announced that it was exploring strategic alternatives. Genomics engaged a financial advisor, which reached out to 42 parties potentially interested in a transaction. Nine signed confidentiality agreements (four of those included standstill provisions), and at least one of those included a "don't ask, don't waive" standstill provision. In September 2012, BGI and Genomics entered into a merger agreement.

Vice Chancellor Laster enjoined Genomics from enforcing the "don't ask, don't waive" standstill provision because "[b]y agreeing to this provision, the Genomics board impermissibly limited its ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders."[7]

Ancestry.com. *Ancestry.com* involved a going-private transaction in which Ancestry.com entered into a confidentiality agreement that also included a "don't ask, don't waive" provision. Chancellor Strine's bench ruling, published about three weeks after the *Genomics* bench ruling, stated that these provisions were not *per se* invalid, although Chancellor Strine concluded that Ancestry.com's public disclosures regarding the nature of the restriction were not sufficient.

In discussing the issue, Chancellor Strine observed that the Delaware courts have been reluctant to create bright-line rules invalidating, in all cases, contract provisions in mergers. "Per se rulings where judges invalidate contractual provisions across the bar are exceedingly rare in Delaware, and they should be.... This Court is a court of equity, and usually we're dealing with the [question of whether something is equitable under the circumstances]. And it's usually for the Legislature to determine when something is per se unlawful."[8]

Chancellor Strine recognized the analysis in *Genomics*, as well as the *In Re Celera Corporation Shareholder Litigation* case from earlier in 2012 in which Vice-Chancellor Parsons also expressed concern about the effect of a "don't ask, don't waive" standstill provision, particularly when taken together with a no shop provision.[9] Chancellor Strine pointed out, however, that *Celera* expressly stated that the court was not adopting a *per se* rule against "don't ask, don't waive" provisions, and that there was no prior ruling of the Delaware courts to that effect. "I think what *Genomics* and *Celera* both say, though, is [w]oah, this is a pretty potent provision ... [and] directors need to use [these provisions] consistently with their fiduciary duties, and they better be darn careful about them."[10] While not explicitly rejecting *Genomics*, Chancellor Strine's decision clearly departs from it.

SO WHERE DOES THIS LEAVE US?

We do not conclude from these cases that "don't ask, don't waive" standstill provisions are unenforceable *per se* and continue to believe that they should be included in standstills signed up at the outset of a strategic assessment process in appropriate circumstances. These provisions can effectively incentivize acquirers to make their best bids at a time in the auction process, thereby increasing the likelihood that stockholder value will be maximized. As such, we think that these provisions can and should be enforceable.

5 *Ancestry.com* at 20.
6 *Genomics* at 13.
7 *Id.* at 18.
8 *Ancestry.com* at 20-21.
9 *See In re Celera Corporation Shareholder Litigation*, 2012 WL 1020471 (Del. Ch. March 23, 2012).
10 *See Ancestry.com* at 22.

Chancellor Strine's admonition that there is no *per se* rule against "don't ask, don't waive" standstill provisions, made after *Genomics,* should be observed in other cases, and the specific facts in *Genomics* will afford the courts the ability to do what they think is right. As with other merger process issues, we think that courts will consider the extent to which the deal was shopped originally, the number of potential buyers, and the extent to which the stockholders have committed to supporting the transaction.[11] In addition, courts will consider the quality of the process and information that was provided to the bidder that is bound by the "don't ask, don't waive" standstill provision and may be excluded from continuing in the bidding once a merger agreement is signed with another party. The case for supporting a "don't ask, don't waive" provision will be strongest in instances where an excluded acquirer was given a full and fair opportunity to submit its best bid before the target entered into a definitive agreement.

An important lesson of *Ancestry.com* is that a target's board should be informed of the key elements of the bidding process in general, and that the process advisors need to be sure to create the record that appropriately reflects this. Although we do not believe that these cases require extensive oversight on these matters by the board, we do think that more involvement than has historically been the case may now be needed. At the very least, the board should be apprised of the approach taken with the confidentiality and standstill agreements, and should consider and approve the approach utilized in the process.

A LAST MOMENT ON THE SOAP BOX

We prefer the principle expressed *In re Cogent, Inc. Shareholder Litigation*. There, in the context of an auction where the target board chose a bidder who offered less but more certain consideration, Vice Chancellor Parsons wrote that "[o]ur case law makes clear that there is no single path that a board must follow in order to reach the required destination of maximizing stockholder value. Rather, directors must follow a path of reasonableness which leads toward that end."[12] We think that this same deference should be given to the tactical decision-making of the board in this context.

Cases like *Genomics* and other decisions since the financial crisis in which the board's oversight powers have been nit-picked seem to proceed from the assumption that the board is not really on the job.[13] Real-life experience, however, indicates that this is not at all the case. Boards of directors and managements of target companies should be permitted to make rational decisions regarding negotiating strategy and the tactics of the auction process. The *Genomics* court was concerned by the prospect of directors willfully blinding themselves to potential higher bids in the future. But what incentive do they have to do that? In our experience, target boards in fact do their best to maximize stockholder value, including in circumstances in which management may have conflicting interests like leveraged buy-outs. Moreover, in addition to complying with their fiduciary duties, directors of target companies are almost always stockholders of the target and stand to personally benefit financially from maximizing the sale price. In the absence of any conflict of interest, why wouldn't they elect the path that they felt gave the company its best opportunity to get the highest price? If the board does elect to utilize a standstill that includes a "don't ask, don't waive" provision, isn't it more likely that it did so because it thought that was the best tactical approach to running the auction?

Given the ambiguity created by *Genomics*, however, deal practitioners need to decide how to proceed with respect to standstills in the auction process. Some have seemed to suggest that "don't ask, don't waive" provisions be abandoned in light of *Genomics*.[14] We think that goes too far and, as Chancellor Strine explained in *Ancestry.com*, is inconsistent with Delaware's principle-based jurisprudence in

11 These were important considerations in the *Genomics* and *Celera* cases. *See* C.A. No. 7888-VCL, 10 (Del. Ch. Nov. 9, 2012) (transcript); *see Celera* at 22.

12 *In re Cogent, Inc. S'holder Litig.*, 7 A.3d 487, 497 (Del. Ch. 2010).

13 *See*, e.g., *In re El Paso Corp. S'holders Litig.*, 41 A.3d 432 (Del. Ch. 2012).

14 *See*, e.g., *Commentary,* "Delaware Chancery Court Enjoins 'Don't Ask, Don't Waive' Standstill Provision and Conditionally Denies Injunction on Deal Protections," Sullivan and Cromwell (Nov. 30, 2012); *Commentary*, "Delaware Court Enjoins 'Don't Ask, Don't Waive' Standstill Provision," Winston and Strawn (Dec. 2012).

the merger context. As noted above, the board should be informed about the recommended auction process terms, including the standstill, and confirm the approach based on recommendations of outside advisors. Given that Chancellor Strine and Vice-Chancellor Laster were focused on the impact of the provision on potential post-signing competing bids, the more prudent approach for targets may be to continue to push for the provision and waive or condition it, if at all, only at the time a definitive agreement is signed. In certain circumstances, it may even be appropriate for targets to specifically condition the provisions of merger agreements requiring them to enforce confidentiality agreements by reference to a fiduciary out, limited perhaps to participants in the process who did not receive detailed information or did not submit actual proposals. In all events, targets ought to be consistent in their approach to standstills; one of the unexplained, but potentially troublesome, aspects of *Genomics* was the apparent inconsistency in the various confidentiality agreements signed by participants in the process.

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