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Expert Analysis

Delaware Court Provides Guidance On Sale Process, Exclusivity, Conflict Disclosure in Proxy

By Gardner Davis, Esq., and John Wolfel, Esq.
Foley & Lardner

The Delaware Chancery Court recently provided helpful guidance for corporate boards and their M&A advisers regarding management of the sale process, the grant of exclusivity and the need for full disclosure of conflicts of interest to shareholders in the proxy statement.

HEIGHTENED SENSITIVITY?

In *In re Atheros Communications Shareholder Litigation*, No. 6124-VCN, 2011 WL 864928 (Del. Ch. Mar. 4, 2011), Vice Chancellor John Noble sustained the board's sophisticated handling of the process leading to the sale of the company, including its decision to grant exclusivity to the potential buyer, but faulted the company for its failure to make sufficiently robust disclosure in the proxy statement regarding the contingent nature of the investment banker's compensation and the CEO's expectation of continuing employment with the acquirer.

At the risk of reading too much into the tea leaves, *Atheros*, considered in conjunction with the Chancery Court's decision three weeks earlier in *In re Del Monte Foods Co. Shareholder Litigation*, 2011 WL 532014 (Del. Ch. Feb. 14, 2011), suggests a heightened sensitivity to investment bankers' potential conflicts of interest that may compromise their loyalty and objectivity, as well as an increased willingness to grant injunctive relief to delay stockholder votes and require additional disclosure.

Unlike in *Del Monte*, where the court confronted serious issues of potential investment banker misconduct, the sale process in *Atheros* was fundamentally solid and the plaintiffs' contentions regarding the inadequacy of disclosure are relatively minor. But the Chancery Court appears focused on the crucial role of investment bankers in today's M&A environment and committed to raising the bar regarding potential conflicts that may compromise their ability to provide objective advice.

PASSING MUSTER

Considering the outcome of *Atheros*, particularly in the shadow of *Del Monte*, the unwritten lesson may be that a deal will have a better chance of passing muster if the investment banker's fee is less dependent upon providing the fairness opinion and the deal closing. The Chancery Court apparently believes the "all or nothing" fee structure compromises the investment banker's practical ability to recommend against a deal as not being in the stockholders' best interest.

The *Atheros* decision arises from Qualcomm Inc.'s $3.1 billion all-cash acquisition of Atheros Communications. Atheros, a pub-licly traded Delaware corporation, is in the business of designing communica-tions solutions for wireless and wired communication products using metal oxide semi-conductor processes.

Qualcomm, a much larger public company, manufactures mobile phone chips and offers digital wireless communication products and services.

In 2005 Atheros and Qualcomm formed a strategic partnership that allowed Atheros to develop products that were compatible with Qualcomm's mobile communication platforms.

Atheros, in conjunction with an earlier opinion, suggests a heightened sensitivity to investment bankers' potential conflicts of interest that may compromise their loyalty and objectivity.

THE NEGOTIATIONS

In the spring and summer of 2010, management of Atheros and Qualcomm discussed the possibility of a business combination. At a regularly scheduled meeting Aug. 17, the Atheros board first approved the discussions and authorized management to provide Qualcomm with additional information.

Atheros engaged Qatalyst Partners, an independent investment bank focusing on the technology industry, as its financial adviser. Frank Quattrone, perhaps Silicon Valley's most prominent investment banker during the 1990s tech boom, founded Qatalyst in 2008.

Atheros and Qatalyst negotiated the terms of the engagement for more than three months, during which Qatalyst advised the board regarding negotiations with Qualcomm and other strategic options. The Atheros board pushed back regard-ing Qatalyst's requested total fee and the extent of the "tail" provision in the event Atheros closed a future deal with a company other than Qualcomm.

About a week before Atheros signed the merger agreement, Qatalyst and Atheros agreed that the investment bank would be paid a flat fee, of which 98 percent would be contingent upon the closing of the Qualcomm transaction. The final negotiated fee was substantially lower than that originally sought by Qatalyst.

THE BOARD'S ROLE

It should be noted that the Atheros board took an active role from an early stage of the sale process. Of the board's eight directors, seven were disinterested and independent. The Atheros board met 12 times, usually with Qatalyst and outside legal counsel, to discuss the state of negotiations with Qualcomm and to provide instructions for management.

The Atheros board set a proactive tone for the process by immediately conven-ing a special meeting with management and its financial adviser on the day that Qualcomm presented its initial offer. At that Nov. 8 meeting, the board requested that Qatalyst address the board at its next meeting "on various topics including the Qualcomm proposal, the company's strategic alternatives and a valuation analysis."[1]

The board met a week later to continue discussions regarding Qualcomm's proposal, during which Qatalyst made a presentation "regarding Qualcomm's proposal and the company's strategic alternatives."[2] The board also discussed other potential acquirers that might be willing to pay a higher price than the opening Qualcomm offer.

The board asked Qatalyst to provide information on other possible bidders. After determining that Qualcomm's original offer was not sufficient, the board directed management to inform Qualcomm that its proposed price was inadequate and to make a counteroffer.

The Atheros board met again Dec. 1 to discuss the possibility of initiating contact with other potential acquirers. The board reviewed a list of 11 companies, including Qualcomm, that may be interested in acquiring Atheros. The board also considered whether a financial investor might be interested in acquiring the company.

The Chancery Court appears focused on the crucial role of investment bankers in today's M&A environment and committed to raising the bar regarding potential conflicts.

The board, with Qatalyst's assistance, identified two other companies, referred to as Company A and Company B in the proxy statement, "that it believed were most likely to pay the highest price for the company."[3] The board authorized management and Qatalyst to continue negotiations with Qualcomm and to initiate discussions with the two other companies. In addition, the board sought information from Qatalyst regarding a fourth company, referred to as Company C in the proxy statement.

Qatalyst contacted Company A and Company B Dec. 1 and 2, respectively. Company A stated that it would consider a transaction with Atheros internally before answering. When Qatalyst again asked Company A Dec. 6 if it was interested in discussing a transaction with Atheros, Company A replied that it had not yet made a determination. Company B responded the day after Qatalyst's original inquiry that it had no interest in merging with Atheros.

THE CANDIDATE LIST NARROWS

After evaluating information from Qatalyst, the board determined that Company C was unlikely to complete any kind of business combination with Atheros based on its historical lack of any large-scale transactions. Therefore, the board decided not to pursue acquisition discussions with Company C.

Qualcomm submitted a higher offer Dec. 6. However, it conditioned the improved offer on Atheros' entering into an exclusivity agreement before proceeding further.

The Atheros board met the following day to consider Qualcomm's new proposal and the required exclusivity agreement.

After repeated inquiries by Qatalyst into Company A's interest in Atheros, Company A requested a meeting Dec. 8. On Dec. 11, Atheros provided Company A with a presentation largely the same as that given to Qualcomm and informed its representatives that Atheros was imminently entering into an exclusivity agreement.

Qualcomm continued to demand exclusivity before it would further discuss the transaction. The Atheros board met Dec. 11. Qatalyst briefed the board on efforts to evaluate the interest of companies other than Qualcomm, including Company B's lack of interest and that Company A had not indicated on what timeframe, if at all, it might make an offer. After determining that a significant risk existed that Qualcomm might abandon the transaction if Atheros refused to grant exclusivity, the board unanimously authorized granting exclusivity to Qualcomm.

The Atheros board unanimously approved the merger agreement Jan. 4. The proposed $45-per-share price represents an approximate premium of 21 percent over Atheros' closing price of $37.02 on Jan. 3, which was the last full trading day before rumors of the transaction were made public.

Following announcement of the deal, several shareholders sued, seeking to e njoin the proposed sale of Atheros to Qualcomm. The plaintiffs alleged the standard panoply of claims, including that the board breached its fiduciary duty by conducting an inadequate sale process and that the proxy statement contained material omissions.

Vice Chancellor Noble made short work disposing of the *Revlon*[4] claims against the Board.

"[W]what typically drives a finding of unreasonableness is evidence of self-interest, undue favoritism or disdain towards a particular bidder, or a similar non-stockholder-motivated influence that calls into question the integrity of the process," the judge wrote, quoting *Del Monte*.[5]

The court found "no basis to question the board's good-faith desire to maximize shareholder value."

Given the strong majority of disinterested and independent directors and the board's active engagement throughout the sale process, Vice Chancellor Noble found "no basis to question the board's good-faith desire to maximize shareholder value."[6]

The plaintiffs specifically attacked the board's decision to grant exclusivity because Company A had requested information and may have submitted a superior offer.

"There is no suggestion in the record that the board was biased against Company A or that it was trying to short-circuit discussions with other potential bidders," Vice Chancellor Noble said. "Rather, Company A, despite its awareness that Atheros was moving quickly with another acquirer and that it intended to go exclusive in the coming days, offered little indication that it anticipated making a serious offer."[7]

The judge found that the board "made a reasonable judgment to pursue Qualcomm's definite offer — which was conditioned upon exclusivity — instead of continuing discussions with Company A at the risk of Qualcomm abandoning any transaction altogether."[8]

REVLON CLAIMS STRIKE OUT

The plaintiffs also contend the board breached its *Revlon* duties by agreeing to burdensome deal-protection terms that precluded other bids. The allegedly offensive terms included a no-solicitation clause, matching rights and a termination fee equal to about 3.3 percent of the total transaction value. Vice Chancellor Noble said "provisions such as these are standard merger terms, are not per se unreasonable and do not alone constitute breaches of fiduciary duty."[9]

The plaintiffs also challenged the sufficiency of the disclosure to shareholders in the Atheros proxy statement regarding Qatalyst's compensation arrangement. The proxy statement said Qatalyst would "be paid a customary fee, a portion of which is payable in connection with the rendering of its opinion and a substantial portion of which will be paid upon completion of the merger."[10]

However, the proxy statement did not include the amount of compensation that Qatalyst would receive or, more importantly to Vice Chancellor Noble, the quantification of the amount of the fee that is contingent — about 98 percent.

"Financial advisers, such as Qatalyst, serve a critical function by performing a valuation of the enterprise upon which its owners rely in determining whether to support a sale," Vice Chancellor Noble said. "Before shareholders can have confidence in a fairness opinion or rely upon it to an appropriate extent, the conflicts and arguably perverse incentives that may influence the financial adviser in the exercise of its judgment and discretion must be fully and fairly disclosed."[11]

The judge said: "Although the proxy statement reports that a 'substantial portion' of the fee is contingent, the percentage of the fee that is contingent exceeds both common practice and common understanding of what constitutes 'substantial.' Contingent fees are undoubtedly routine; they reduce the target's expense if the deal is not completed; perhaps, they properly incentivize the financial adviser to focus on the appropriate outcome."[12]

DISCLOSURE CLAIMS HAVE TRACTION

"[T]he differential between compensation scenarios may fairly raise questions about the financial adviser's objectivity and self-interest," Vice Chancellor Noble wrote. "Stockholders should know that their financial adviser, upon whom they are being asked to rely, stands to reap a large reward only if the transaction closes and, as a practical matter, only if the financial adviser renders a fairness opinion in favor of the transaction. In essence, the contingent fee can readily be seen as providing extraordinary incentive for Qatalyst to support the transaction."[13]

The judge found that the contingent fee arrangement created such substantial incentives that stockholders should be made aware of it and that the contingent fee structure is material to the stockholders' decision to support or oppose the transaction.

"[I]t is clear that an approximately 50:1 contingency ratio requires disclosure to generate an informed judgment by the shareholders as they determine whether to rely on the fairness opinion in making the decision to vote for or against the transaction," he said.[14]

The defendants argued that because the fee agreement between Qatalyst and Atheros was reached shortly before the merger agreement was signed, the practical risk was very small that the deal would not close, and therefore the "contingent" nature of the fee was not material.

Vice Chancellor Noble concluded, however, that "the unusual timing supports the fullest disclosure. More specifically, the potentially pernicious incentives warrant disclosure regardless of the time remaining."[15]

The plaintiffs also contended that the amount of Qatalyst's fee needed to be disclosed. Although Vice Chancellor Noble concluded that it was not necessary to make a specific ruling on whether the amount of compensation must always be disclosed, he concluded that under the circumstances, particularly because corrective disclosure would be required, "the stockholders should be afforded an opportunity to understand fully the nature and means by which Atheros will compensate Qatalyst. Thus, that would include the amount of the fees as well."[16]

THE CEO'S DEAL

Finally, the plaintiffs argued that the proxy statement inaccurately described the negotiations over the compensation the Atheros CEO would receive when he joined Qualcomm after the deal closed. The plaintiffs said the CEO's future with Qualcomm could have influenced him, in his role as Atheros' lead negotiator, to take a less aggressive stance on behalf of its stockholders.

Although not mentioned in the opinion, Atheros' filings with the Securities and Exchange Commission indicate that its CEO held 136,453 shares and vested, exercisable options for an additional 504,354 shares. Given the CEO's substantial economic interests as a shareholder, it appears a remote risk that the CEO's efforts to maximize Atheros' shareholder value would be compromised by the opportunity to work for Qualcomm.

Vice Chancellor Noble acknowledged the proxy statement "contains robust disclosures regarding the terms of [the CEO's] post-closing employment that dispel any notion that [he] had no expectation when the merger agreement was finalized regarding how he would be treated by Qualcomm."[17]

Nevertheless, Vice Chancellor Noble found that the statement in the proxy statement that before Dec. 14 the Atheros CEO "had not had any discussion with Qualcomm regarding the terms of his potential employment by Qualcomm" was materially misleading because as of an earlier date the CEO had "overwhelming" reason to believe he would be employed by Qualcomm after the deal closed.[18]

Therefore, the Chancery Court found the disclosure misleading and that additional disclosure of the date on which the CEO learned from Qualcomm that it intended to employ him after closing was required.

The Chancery Court entered a preliminary injunction delaying the stockholder meeting or stockholder vote on the merger until after appropriate curative disclosures could be made to address the deficiencies found in the proxy statement.

NOTES

1. *In re Atheros Commc'ns S'holder Litig.*, 2011 WL 864928, at 7 (Del. Ch. Mar. 4, 4011).
2. *Id.*
3. *Id.* at 9.
4. *Revlon Inc. v. MacAndrews & Forbes Holdings,* 506 A.2d 173 (Del. 1986).
5. *Atheros*, at 16 (quoting *In re Del Monte Foods Co. S'holders Litig.,* 2011 WL 532014, at *15 (Del. Ch. Feb. 14, 2011)).
6. *Atheros* at 17.
7. *Id.* at 19.
8. *Id.* at 19-20.
9. *Id.* at 20 (quoting *In re 3Com S'holders Litig.,* 2009 WL 5173804, at *7 (Del. Ch. Dec. 18, 2009)).
10. *Id.* at 22.
11. *Id.* at 21-22.
12. *Id.* at 22-23.

[13] *Id.* at 23.

[14] *Id.* at 24.

[15] *Id.* at 25, n. 69.

[16] *Id.* at 25.

[17] *Id.* at 31.

[18] *Id.*


Gardner Davis (left) is a partner and **John Wolfel** (right) is an associate in the transactional and securities practice of **Foley & Lardner** in Jacksonville, Fla. The authors can be reached at gdavis@foley.com and jwolfel@foley.com, respectively.