FROM THE CHAIR
By Richard E. Climan

The Committee on Negotiated Acquisitions will hold its Fall 2005 stand-alone meeting on Saturday, October 22, at the Four Seasons Hotel in Las Vegas. Our Committee meeting will be preceded by separate subcommittee, task force and working group meetings throughout the day Friday and on Saturday morning. This will be the Committee’s first visit to Las Vegas. Based on the registrations received so far, I’m expecting a heavy turnout.

At our full Committee meeting on Saturday afternoon, James Politi, a reporter for the Financial Times, will lead a discussion of the role of the media in M&A transactions. Immediately after the Committee meeting, there will be a Committee Forum presentation entitled “A Primer on Appraisal Rights for the M&A Lawyer.” We are privileged to have Chief Justice Myron Steele of the Delaware Supreme Court joining Rick Alexander and Mark Morton as panelists on what promises to be a highly informative program.

There will be two Committee receptions in Las Vegas, the first on Friday evening at the Four Seasons Hotel and the second on Saturday evening at Café Ba Ba Reeba. Many thanks to Houlihan Lokey Howard & Zukin and Merrill Corporation for sponsoring these events.

(continued on next page)
There have been some recent changes in our Committee’s leadership. I have appointed Daniel Rosenberg and Jim Walther co-chairs of the Subcommittee on International Acquisition Transactions. Nat Doliner and Stan Freedman will serve as vice chairs of this subcommittee. We are indebted to John Leopold for the many years he devoted to co-chairing, and then chairing, the task force that was the predecessor to this subcommittee.

Tom Thompson has replaced Neal Brockmeyer as chair of the Programs Subcommittee. We are very grateful to Neal for his fine efforts in this role over the past several years.

George Taylor has assumed the position of chair of our Technology Subcommittee, and Mike Reilly has taken over as editor of Deal Points. Mark Morton, who did a superb job during his tenure as editor of Deal Points, has been appointed vice chair of the Task Force on the Dictionary of M&A Terms. (David Katz continues to chair that task force.) Finally, Hendrik Jordaan and Deborah Telman have become vice chairs of the Membership Subcommittee, chaired by Wilson Chu.

Congratulations are in order for our (recently disbanded) MAPP Task Force. That task force, under the leadership of Vince Garrity and Tom Thompson, produced “The M&A Process: A Practical Guide for the Business Lawyer,” which is now available for sale through the ABA.

Our Committee is sponsoring the Tenth Annual National Institute on Negotiating Business Acquisitions, which is being presented in Washington, D.C., on November 10 and 11. As you may recall, this program was originally scheduled to be presented in New Orleans. We are hoping that next year’s National Institute program can be held there.

I look forward to seeing many of you in Las Vegas.

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**FEATURE ARTICLE**

**Clarity or Confusion:**
The 2005 Amendment to Section 271 of the Delaware General Corporation Law

By Mark A. Morton and Michael K. Reilly

**Introduction.**

Although Delaware courts have recognized the separate corporate existence of parent and subsidiary corporations, the close relationship between those entities sometimes raise questions about the proper application of Delaware law. For example, many practitioners have struggled with how Section 271 of the General Corporation Law of the State of Delaware (“Section 271”), which requires a stockholder vote if a corporation intends to sell, lease or exchange all or substantially all of its assets, should operate in the parent/subsidiary context. In particular, some have questioned whether a vote of a parent corporation’s stockholders should be required in transactions involving a drop down of assets to a subsidiary, or a sale of assets by a subsidiary. Nevertheless, over the years, some practitioners developed a reasoned analysis for determining when a stockholder vote under Section 271 would be required in those circumstances.

That reasoned analysis was challenged when the Court of Chancery issued its decision in *Hollinger International, Inc. v. Black*. In that lengthy decision, the Court of Chancery rejected an

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argument that the vote of a parent corporation’s stockholders was not required to approve a sale of assets owned by its indirect, wholly owned, non-Delaware subsidiary. The Court’s apparent willingness to collapse the corporate existence of the parent and subsidiary corporations in Hollinger for purposes of Section 271 prompted many to consider what effect the decision would have on the reasoned analysis many had offered before when addressing dispositions of assets in the parent/subsidiary context.

Following on the heels of the Hollinger decision, the Delaware General Assembly recently amended Section 271 to specifically provide that the assets of a wholly owned and controlled subsidiary will be considered the assets of its parent corporation for purposes of Section 271. While new Section 271(c) clarifies when a stockholder vote is required for certain asset dispositions under Delaware law, the amendment also raises a host of interesting questions.

I. The Understanding of the Law Prior to Hollinger.

Section 271 is a Delaware statutory provision that requires a stockholder vote for any sale, lease or exchange of “all or substantially all” of a corporation’s assets. Section 271(a) provides, in pertinent part, as follows:

Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets, including its goodwill and its corporate franchises, upon such terms and conditions and for such consideration, which may consist in whole or in part of money or other property, including shares of stock in, and/or other securities of, and other corporation or corporations, as the board of directors of governing body deems expedient and for the best interests of the corporation, when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon…. at a meeting duly called upon 20 days notice….4

Prior to the amendment to Section 271, it was unclear how Section 271 applied in the parent/subsidiary context. For example, it was not clear if the drop down of a corporation’s assets to a wholly owned subsidiary triggered a stockholder vote under Section 271. In addition, it was not clear whether a vote of a parent corporation’s stockholders would be required to approve a sale by its wholly owned subsidiary of assets that would constitute (on a consolidated basis) all or substantially all of the assets of the parent corporation.

A. Drop Down of Assets by Parent to Subsidiary.

Prior to Section 271(c), the drop down of assets by a parent corporation to its wholly owned subsidiary raised interpretational issues under Section 271 because it was not clear that the parent was disposing of its assets in a manner that should have required a stockholder vote under that statutory provision. On the one hand, one could view a drop down of assets to a wholly owned subsidiary as a non-event for the stockholders of the parent corporation because the parent corporation retains ownership of the assets, albeit indirectly. As evidence of that fact, it is likely that the assets of the subsidiary would be consolidated with the assets of the parent corporation for accounting purposes. In addition, to the extent the

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3 The amendment to Section 271 was effective August 1, 2005.

4 8 Del. C. § 271(a).
assets were transferred to the subsidiary as a capital contribution (and not in exchange for the issuance of additional shares of the subsidiary) one could argue that there was a transfer, but not a sale, lease or exchange, of assets of the parent. Thus, it is arguable that no vote of the parent corporation’s stockholders should be required for that drop down.

On the other hand, Delaware law generally recognizes the separate corporate existence of entities. If the separate corporate existence of parent and subsidiary is recognized, then it might be difficult to conclude that the assets, after the drop down, remain the assets of the parent corporation. If so, then the subsidiary, as a separate corporate entity, should be entitled to dispose of the assets without a vote of the stockholders of the parent corporation. The concern raised by the result is another basis for arguing that a drop down of assets should require a vote of the parent’s stockholders under Section 271.

In view of that tension, it has often been difficult to provide advice on the issue of whether a stockholder vote is required for a drop down of assets. Some practitioners have been able to conclude that no stockholder vote should be required for a drop down, but a vote should be required for a sale by the subsidiary of those assets. Prior to Hollinger, some argued that no vote of a parent corporation’s stockholders would be required for a sale of assets by a subsidiary. As a general matter, that conclusion was based on the assumption that the assets were not dropped down to the subsidiary for the purposes of avoiding a vote under Section 271. Therefore, so long as the assets were either never owned directly by the parent corporation, or had been held at the subsidiary level for a significant period of time, it was possible to conclude that no vote would be required. In addition, the conclusion also was based on facts demonstrating an absence of fraud or any reason to pierce the corporate veil and collapse the corporate

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5 See, Leslie v. Telephonics Office Techs., Inc., C.A. No. 13045, 1993 WL 547188, Allen, C. (Del. Ch. Dec. 30, 1993). Cf. Landgarten v. York Research Corporation, C.A. No. 8417, 1988 WL 7392, at *4, Berger, V.C. (Feb. 3, 1988) (stating in a § 220 action that “[n]ormally, the separate corporate existence of a subsidiary will not be disregarded....Rather, there must be a showing of fraud or that the subsidiary is the ‘alter ego’ of the parent”); S.B. No. 127, 142d General Assembly, 74 Del. Laws Ch. 84 (2003) (stating in the synopsis that the amendments to Section 220 were “not intended to affect existing legal doctrine that, as a general matter, respects the corporate existence of subsidiaries in relation to liability of stockholders to third parties, personal jurisdiction over subsidiaries of Delaware corporations, and discovery in litigation other than under Section 220”).
existence of the parent and subsidiary corporations. 6

II. The Hollinger Decision.

In Hollinger, Hollinger International, Inc. (the “Parent”) had entered into an agreement to sell the assets (the “Telegraph Group”) of its indirect, wholly owned subsidiary, Telegraph Group Ltd. (England) (the “Subsidiary”). Among other things, Subsidiary published the Telegraph, a leading newspaper in the United Kingdom in terms of both circulation and journalistic reputation. Hollinger, Inc., an entity indirectly controlled by Conrad Black and the controlling stockholder of Parent, commenced a suit in the Court of Chancery seeking to enjoin the sale on the grounds that the stockholders of Parent had the right to vote on the sale because, although held by a subsidiary, the Telegraph Group constituted all or substantially all of the assets of Parent. Parent argued that the Telegraph Group did not constitute all or substantially all of its assets on a consolidated basis, and, even if it did, that no vote of the stockholders of Parent was necessary because the sale involved assets owned by Subsidiary and not Parent.

The Court refused to decide the matter on the latter “technical statutory defense,” and instead treated the assets of Subsidiary as if such assets were owned directly by Parent. 7 Having decided to treat the assets as those of Parent, the Court ultimately concluded that the Telegraph Group did not constitute all or substantially all of the assets of Parent, and thus no vote of Parent’s stockholders was required.

Contrary to the prior dicta on the issue, the Court in Hollinger expressed skepticism with respect to the technical statutory argument that a vote of the stockholders of Parent was unnecessary under the facts of the case. Without addressing at length the literal language of the statute, the Court decided to treat the Telegraph Group as if it was owned directly by Parent in light of the fact that, “as a matter of obvious reality,” the sale process was directed and controlled by Parent. 8

In reaching that conclusion, the Court noted that none of the subsidiaries, including the Subsidiary, engaged independent financial or legal advisors. Moreover, all of the directors of the subsidiaries were officers of Parent, and those directors had a role in the sale, in their capacity as directors, only after the terms of the sale were

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6 The view that no vote of the parent corporation’s stockholders should be required was based on two main components: (i) the plain language of Section 271; and (ii) the dicta of various decisions of the Delaware Court of Chancery. In particular, by its express terms, Section 271 applies only to the sale, lease or exchange by a corporation of “its” assets. Accordingly, one could argue that the only stockholder vote required by Section 271 was the vote of the stockholders of the corporation whose assets are being sold. In the parent/subsidiary context, that meant that only the sole stockholder of the subsidiary should vote on an asset sale by the subsidiary. In addition, dicta in certain decisions of the Court of Chancery suggest that in most cases no vote of the parent corporation’s stockholders should be required. See Leslie v. Telephonics Office Techs., Inc., C.A. No. 13045, 1993 WL 547188, Allen, C. (Del. Ch. Dec. 30, 1993) (suggesting that separate corporate identities will not lightly be disregarded in the context of a sale by a subsidiary of its assets and, more specifically, that absent fraud or a showing of facts that would justify piercing the corporate veil, no vote of a parent corporation’s stockholders is required by Section 271 for the sale, lease, or exchange of the assets of a subsidiary, even if such assets constitute all or substantially all of the assets of the parent and its subsidiaries on a consolidated basis); J.P. Griffin Holding Corp. v. Mediatrics, Inc., C.A. No. 4056, 1973 WL 651, Marvel, V.C. (Del. Ch. Jan. 30, 1973) (“[I]n as much as defendant is the record holder of all of the shares of its subsidiary ... and has voted all of said shares in favor of such a sale, the provisions of 8 Del. C. § 271 would appear to have been met.”).

7 Hollinger, 858 A.2d at 348.

8 Id. at 372. The Court reasoned that a ruling on the technical statutory defense would “render § 271 an illusory check on unilateral board power at most public companies.” Id. at 348. While acknowledging that a “technical” statutory defense would “involve a rational reading of § 271,” the Court noted that it did not represent the only possible interpretation of that statute. Id.
completed. In addition, the terms of the relevant contract evidenced the fact that Parent directed the sale process. Not only was Parent a signatory to the contract, but its legal advisors negotiated the terms of the contract. Pursuant to those terms, Parent agreed to cause Subsidiary to perform its obligations under the contract, guaranteed the payment of any breach of warranty claims brought against Subsidiary by the purchaser, and was entitled to receive payments from claims belonging to its subsidiaries.

With those facts in mind, the Court considered the policy implications of determining whether a vote of the stockholders of Parent was required in such circumstances. The Court noted that the technical statutory argument that a stockholder vote was not required had policy arguments in its favor because that argument “has virtues that accompany all bright-line tests, which are considerable, in that they provide clear guidance to transactional planners and limit litigation.” The Court continued as follows:

That approach also adheres to the director-centered nature of our law, which leaves directors with wide managerial freedom subject to the strictures of equity, including entire fairness review of interested transactions. It is through this centralized management that stockholder wealth is largely created, or so much thinking goes.

However, the Court also found that a conclusion in favor of requiring a stockholder vote in the circumstances had policy arguments in its favor. In particular, the Court noted that accepting the technical statutory argument would render Section 271 “largely hortatory – reduced to an easily side-stepped gesture, but little more, towards the idea that transactions that dispose of substantially all of a corporation’s economic value need stockholders’ assent to become effective.” The Court noted such a conclusion would allow a corporation to sell all of its assets through its subsidiaries, that “would, taken together, result in a de facto liquidation of the firm’s operating assets into a pool of cash, a result akin to a sale of the entire company for cash or liquidation.” The Court reasoned that, although the law recognizes the separate existence of wholly owned subsidiaries for purposes of minimizing liability to third parties and tax liability, it does not necessarily mean that the law should recognize their separate existence for all purposes.

Ultimately, the Court declined to rule on the issue and instead assumed, without deciding, that the Telegraph Group was held directly by Parent. Nevertheless, to most practitioners, the Court’s analysis was read as a strong indication of the Court’s willingness, under the appropriate circumstances, to ignore the legal distinction between parent and subsidiary corporations at least for purposes of analyzing whether a stockholder vote was required under Section 271.

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9 At that time, the directors of the subsidiaries were brought into a meeting so that they could hear the presentation of Parent’s financial advisor and the final discussion about selling the assets of Subsidiary. After hearing the presentations, the directors of each of the subsidiaries, including Subsidiary, approved the sale at meetings that lasted approximately five minutes each. Id. at 372.

10 Id. at 374.

11 Id.

12 Id.

13 Id.

14 The Court suggests that this distinction may be ignored without harming the utility of a holding company structure: “At first blush, it is not apparent why the distinctive considerations that apply to the relationship between stockholders and corporations within the corporate family cannot be recognized without doing violence to the wealth-creating value of limiting the ability of third parties who deal with wholly owned subsidiaries to seek recourse against parent corporations.” Id. at 375.
III. The Amendment to Section 271.

Effective August 1, 2005, the Delaware General Assembly amended Section 271 to add a new subparagraph (c). Section 271(c) of the General Corporation Law of the State of Delaware (the “Amendment”) provides as follows:

(c) For purposes of this section only, the property and assets of the corporation include the property and assets of any subsidiary of the corporation. As used in this subsection, “subsidiary” means any entity wholly owned and controlled, directly or indirectly, by the corporation and includes, without limitation, corporations, partnerships, limited partnerships, limited liability partnerships, limited liability companies, and/or statutory trusts. Notwithstanding subsection (a) of this section, except to the extent the certificate of incorporation otherwise provides, no resolution by stockholders or members shall be required for a sale, lease or exchange of property and assets of the corporation to a subsidiary.\(^{15}\)

In the synopsis relating to the Amendment, the Delaware General Assembly described the purpose of the amendment as follows:

Section 271 has been amended to add new subsection (c). The purpose of subsection (c) is to provide that (i) no stockholder vote is required for a sale, lease or exchange of assets to or with a direct or indirect wholly owned and controlled subsidiary, and (ii) the assets of such a subsidiary are to be treated as assets of its ultimate parent for purposes of applying, at the parent level, the requirements set forth in subsection (a). The amendment is not intended to address the application of subsection (a) to a sale, lease or exchange of assets by, or to or with, a subsidiary that is not wholly owned and controlled, directly or indirectly, by the ultimate parent.\(^{16}\)

As a result of the Amendment, it is now clear under Delaware law that a vote of a parent corporation’s stockholders is not required to authorize the drop down of all or substantially all of the assets of that parent corporation to a wholly owned and controlled subsidiary. The Amendment also makes it clear that a vote of the parent corporation’s stockholders would be required before its wholly owned and controlled subsidiary sells, leases or exchanges assets that (on a consolidated basis) constitute all or substantially all of the assets of the parent corporation.

It is worth noting, however, that the reasoning of *Hollinger* still applies to an asset sale by a subsidiary that is not wholly owned or controlled. As a result, a vote of the parent corporation’s stockholder might be required if the parent corporation directed and controlled the disposition and the assets constituted all or substantially all of the parent’s assets (on a consolidated basis).

IV. Practical Questions.

Although the Amendment appears to be straightforward, several questions arise when one considers how the Amendment operates in the real world. In order to explore certain of those questions, we consider a hypothetical scenario involving a Delaware corporation named Conglomerate, Inc.

\(^{15}\) 8 Del. C. § 271.

\(^{16}\) H.B. No. 150, 143rd General Assembly, 75 Del. Laws Ch. 30 (2005) (synopsis).
Conglomerate, Inc. ("Conglomerate") was incorporated in Delaware in 1985 as a simple company engaged in the manufacture of widgets. Since the time of its incorporation, Conglomerate has directly owned all of its widget manufacturing assets. As luck would have it, widgets became a highly valuable product during the late 1980s and, bolstered by an optimistic future outlook, Conglomerate became a public company in 1990.

As Conglomerate grew in size, it began to seek to diversify its operations. In its search for new opportunities, Conglomerate learned of a Romanian company named Grommet Co. ("GrommetCo") that manufactured grommets. Realizing the growth potential in the grommet manufacturing industry, Conglomerate purchased all of the shares of stock held by the stockholders of GrommetCo. As a result of the stock purchase, GrommetCo became a wholly owned subsidiary of Conglomerate in 1995. Although GrommetCo has tremendous growth potential, the widget manufacturing business remains the core asset of Conglomerate and currently constitutes more than 75% of Conglomerate’s total income, profit and assets (on a fair market value basis).

On August 1, 2005, Conglomerate decided to drop down its widget manufacturing assets into WidgetCo, a newly-incorporated, wholly owned subsidiary. On August 2, 2005, a buyer approached GrommetCo’s board and expressed an interest in acquiring that business. In connection therewith, Conglomerate’s general counsel contacted outside counsel and has asked what approvals were necessary to drop the assets down to WidgetCo and to effect a sale of GrommetCo.

A. Is a Stockholder Vote Required for the Drop Down?

Although more due diligence would be required to reach a definitive conclusion, it is likely that the widget assets would constitute all or substantially all of the assets of Conglomerate. Nevertheless, the Amendment now makes it possible for a Delaware practitioner to conclude that no vote of Conglomerate’s stockholders is necessary to drop down the widget assets into WidgetCo.

B. What Does “Control” Mean?

In structuring the drop down, the sole ownership requirement is easily satisfied. A more difficult issue arises when one considers whether Conglomerate will control WidgetCo. The Amendment defines a “subsidiary” as “any entity wholly owned and controlled, directly or indirectly, by the corporation.” However, the Amendment fails to provide a definition for “control.” One must, therefore, consider whether WidgetCo would be deemed to be controlled by Conglomerate through ownership alone, or whether other facts must be present to demonstrate Conglomerate’s control over WidgetCo.

Delaware case law does not provide a fixed legal meaning for concept of “control.”

Rather, “its definition varies according to the context in which it is being considered, e.g., fiduciary responsibility, tort liability, filing consolidated tax returns, sale of control.” In determining how “control” would be interpreted in the Amendment, it is useful to examine other provisions in the General Corporation Law of the State of Delaware that include that term.

For example, the Delaware General Assembly recently amended Section 220 of the General Corporation Law of the State of Delaware (“Section 220”) to provide that a stockholder of a corporation may, in certain circumstances, demand to inspect the books and records of a subsidiary of that corporation. Section 220 defines a subsidiary as “any entity directly or indirectly owned, in whole or in part, by the corporation of which the

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18 Id.
stockholder is a stockholder and over the affairs of which the corporation directly or indirectly exercises control....”\(^{19}\) Like the Amendment, Section 220 does not contain a definition of “control.”

The Delaware Supreme Court recently had the opportunity to consider the meaning of “control” in the subsidiary definition set forth in Section 220.\(^{20}\) In interpreting the meaning of “control” in that definition, the Delaware Supreme Court concluded that a parent will be deemed to control a subsidiary for purposes of the definition if the parent has “the power to control the affairs of [the subsidiary] (as distinguished from actually exercising that power).”\(^{21}\)

The definition of subsidiary in Section 220, however, is different than the definition in Section 271. In particular, the definition in Section 220 includes less than wholly owned subsidiaries. The need for the concept of “control” and its meaning in that context is, therefore, more clear. Because the definition in the Amendment includes wholly owned subsidiaries, one could argue that “control” must mean something more than merely the power to control through ownership. Otherwise, the word “control” would be mere surplusage.\(^{22}\) It is possible, therefore, that a Delaware court may construe “control” as requiring a showing of the actual exercise of control over the subsidiary. Until the Delaware courts have an opportunity to address this issue, it is unclear how a Delaware court will construe the concept of “control”.

The interpretational issue concerning the definition of “control” has practical consequences. If Conglomerate does not “control” WidgetCo, a vote of Conglomerate’s stockholders may be required before the assets could be dropped down to WidgetCo. It is, therefore, important for practitioners to consider whether a parent corporation controls its wholly owned subsidiary before dropping assets down to that subsidiary.\(^{23}\)

\(^{19}\) 8 Del. C. § 220.

\(^{20}\) Weinstein, 870 A.2d at 506.

\(^{21}\) Id. at 508. Compare VonFeldt v. Stifel Financial Corp., 714 A.2d 79, 83-85 (Del. 1998) (finding that a director elected to serve on the board of a wholly owned subsidiary is deemed to be “serving at the request of” the parent corporation for purposes of Section 145 of the General Corporation Law of the State of Delaware), with Cochran v. Stifel Financial Corp., C.A. 17350, 2000 WL 286722, at *14, Strine, V.C. (Del. Ch. Mar. 8, 2000) (interpreting Section 145 of the General Corporation Law of the State of Delaware and finding that “the General Assembly took a formalistic approach to the relationship between a parent corporation and the director of a subsidiary the parent elected, and did not assume that corporate parents invariably direct and control the directors of their subsidiaries,” and noting that “a showing that the director merely ‘served [at] the request of’ the parent is insufficient under [Section] 145 to prove ‘agency’ status; the director must go farther and demonstrate that he was the parent’s agent under the traditional agency definition”), aff’d in part, rev’d in part, 809 A.2d 555 (Del. 2002).

\(^{22}\) Grimes v. Alteon Inc., 804 A.2d 256, 264 (Del. 2002) (stating that the Delaware Supreme Court “will avoid interpreting terms [in a statute] as mere surplusage”).

\(^{23}\) Section 203 of the General Corporation Law of the State of Delaware also includes a definition of “control” for purposes of that statutory provision. In particular, “control” is defined as follows:

\[\text{T}h\text{e possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise. A person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary; Notwithstanding the foregoing, a presumption of control shall not apply where such person holds voting stock, in good faith and not for the purpose of circumventing this section, as an agent, bank, broker, nominee, custodian or trustee for 1 or more owners who do not individually or as a group have control of such entity.}\]
C. Should Conglomerate Take Steps to Ensure the Retention of Ownership and Control of the Subsidiary?

In light of the interpretational issues relating to the concept of “control,” one should consider whether Conglomerate’s sole ownership of WidgetCo on the day of the drop down is sufficient, or whether additional steps should be taken to demonstrate Conglomerate’s “control” over WidgetCo. One way to demonstrate Conglomerate’s “control” might be to take steps at the time of the drop down to prevent Conglomerate from losing sole ownership and control of WidgetCo in the future. One could argue that the failure to take steps in advance to prevent the subsequent loss of ownership and control might support a conclusion that Conglomerate did not in fact control WidgetCo on the day of the drop down, and thus a vote of Conglomerate’s stockholders was required for the drop down.

A number of techniques could be employed to ensure that WidgetCo remains wholly owned and controlled by Conglomerate. For example, if WidgetCo issues all of its authorized stock to Conglomerate, then WidgetCo would not be able to issue any additional shares unless it amended its charter to increase the authorized number of shares. Since a charter amendment by WidgetCo would require the approval of Conglomerate (as the sole stockholder of the subsidiary), WidgetCo would not be able to issue shares to a third party without Conglomerate’s consent. As an alternative, WidgetCo’s charter could be drafted so as to require a vote of Conglomerate (as the common stockholder) before the subsidiary could take an action (e.g., the issuance of voting debt or stock options) that would threaten Conglomerate’s sole ownership and control of WidgetCo.

Unless the documents are drafted in this manner, the WidgetCo board of directors, from and after the time of the drop down of assets by Conglomerate, retains the power to cause the subsidiary to no longer be “wholly owned” or “controlled” by Conglomerate. The existence of WidgetCo’s ability, ab initio, raises an interesting interpretational question – can Conglomerate be said to “control” WidgetCo for purposes of Section 271(c) in the absence of specific structure protections in the charter of WidgetCo? If one answers that question “no,” then WidgetCo’s assets should not be deemed to be the assets of Conglomerate for purposes of the Amendment. In that case, the Conglomerate board of directors is left to answer a simple question – was the approval of Conglomerate’s stockholders required under Section 271 to effect the drop down of assets to WidgetCo. This question raises one final problem for the Conglomerate board — since Hollinger suggests that there may be circumstances where a vote of a parent corporation’s stockholder would not be required for a subsequent disposition of assets by the subsidiary (for example, when a parent corporation does not direct or control the disposition), could Conglomerate’s failure to have and maintain control of WidgetCo end up depriving the stockholders of Conglomerate of their right to vote on a future disposition of assets by WidgetCo?

However, while it may be tempting to conclude that the Amendment has opened a Pandora’s Box of legal issues, several countervailing considerations should be raised. First, since it will be the rare case where directors of a wholly owned subsidiary would act to divest the parent of its sole ownership and control of the subsidiary, is it really necessary to incorporate in WidgetCo’s organizational documents the type of structural safeguards suggested above? Indeed, since the directors of a wholly owned subsidiary “are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders,”24 would the Delaware courts permit the WidgetCo board of directors to erode Conglomerate’s ownership or control of WidgetCo without the full support of Conglomerate?

In that connection, we note that a recent decision of the Court of Chancery concluded that advance notice must be given to a director, who also either is a controlling stockholder or represents a controlling stockholder, before the board of directors of that corporation can authorize a transaction resulting in the loss of the stockholder’s control over the corporation. Accordingly, even if a board of directors of a subsidiary decides to authorize such a transaction, notice of that intent likely must be given to Conglomerate. Conglomerate, upon receiving notice through its directors, would be able to exercise its control over the subsidiary to remove the directors and replace them with new directors who would not take that action. Ultimately, however, the courts will have to weigh in to determine the meaning of “control” in the Amendment and whether it is necessary for a parent corporation to take steps to ensure that sole ownership and “control” is maintained by a parent corporation.

D. When Acquiring a New Business (GrommetCo), Should Conglomerate Take Steps to Ensure That It Falls Outside Section 271(c)?

Unlike a pure “drop down” transaction (for example, the contribution of assets to WidgetCo), an acquisition of a new business that will be held within a subsidiary poses different questions and, potentially, different opportunities for a parent corporation. The hypothetical scenario set forth above illustrates some of those differences.

GrommetCo (the recently acquired business) currently accounts for only 25% of Conglomerate’s assets. As such, if Conglomerate sold GrommetCo (or if GrommetCo directly sold its assets on its own) that sale would not trigger a stockholder vote because it would not involve a sale of substantially all of Conglomerate’s assets. However, since the grommet business is growing rapidly, it is possible that those assets might one day constitute (on a consolidated basis) all or substantially all of the assets of Conglomerate. Thus, the question may be asked whether Conglomerate should want to “control” its wholly owned subsidiary, GrommetCo, for purposes of Section 271(c). If it does control GrommetCo, then a sale by GrommetCo (once it has grown to the point where it represents substantially all the assets of Conglomerate) will trigger a vote of Conglomerate’s stockholders under Section 271(c). In contrast, if Conglomerate structures GrommetCo so that it is either not wholly owned or not controlled by Conglomerate, then the Amendment no longer applies. In that case, the rationale of Hollinger (discussed above) suggests that GrommetCo may be able to effect the sale of its assets in the future without seeking the approval of Conglomerate’s stockholders, provided that (among other things) Conglomerate does not direct or control the sales process for its subsidiary.

E. Can GrommetCo (or its Assets) Be Sold in the Future Without a Vote Under Section 271(c)?

Another issue raised by the Amendment is the possibility to structure a transaction – with the support of Conglomerate - between GrommetCo and a buyer that does not trigger a stockholder vote under Section 271. As noted above, the Amendment does not address a scenario in which a parent corporation loses sole ownership or control of a subsidiary after a drop down of assets to that subsidiary. So, for example, if one assumes that the
GrommetCo charter authorizes the issuance of 1000 shares of Common Stock and that GrommetCo only has 100 shares outstanding (all held by Conglomerate), then the GrommetCo board of directors would be permitted to issue and sell 900 additional shares. Under Delaware law, the issuance of such shares may be accomplished without stockholder approval (in the absence of any charter provision to the contrary). Once the buyer has purchased 90% of GrommetCo’s common stock, the buyer may effect a short form merger with GrommetCo pursuant to Section 253 of the Delaware General Corporation Law without any additional action by the GrommetCo board or the other GrommetCo stockholder (Conglomerate). While one may argue that this approach requires the tacit approval of Conglomerate, it is not clear whether that would be sufficient to trigger a stockholder vote of Conglomerate under the rationale of *Hollinger*.

In the event that the foregoing structure was unavailable (because of insufficient authorized common stock or because the buyer and GrommetCo did not wish to undertake that approach), a transaction structure still may be available that does not trigger a stockholder vote of Conglomerate’s stockholders. If the buyer agreed to merge GrommetCo with a subsidiary of buyer, then GrommetCo (and Conglomerate) could argue, based on Delaware’s doctrine of independent legal significance, that the only stockholder vote required for the transaction is the vote required by the merger statute (in this case, the vote of Conglomerate, as the stockholder of GrommetCo, but not the vote of Conglomerate’s stockholders).\(^{26}\)

While one may argue why both of these approaches should, in the right circumstance, avoid a vote under Section 271, it is not clear how a Delaware court would react to such transactional planning.\(^{27}\) Until the Delaware courts (or legislature) offers more guidance in this area, there remains an appreciable risk that a Delaware court would conclude that both structures trigger a vote of Conglomerate’s stockholders because both require Conglomerate to relinquish its control of the subsidiary (either by failing to remove the subsidiary board before it issues shares to the buyer or by affirmatively supporting the planned sale by voting, as a stockholder of GrommetCo, to approve the merger) in order for the transaction to be effected.

**F. How Would a Delaware Court Enforce Section 271 Against a Non-Delaware Subsidiary?**

Assuming that the assets of GrommetCo eventually grow to constitute all or substantially all of the assets of Conglomerate, a question arises concerning how (and whether) a Delaware court would be able to enforce Section 271 against that Romanian entity if it chose to issue one share of stock to a third party and then dispose of its assets without a vote of Conglomerate’s stockholders. Although we do not endeavor to answer that question in detail, we note that Conglomerate’s stockholders could seek to enjoin the transaction by filing an action in the Court of Chancery.\(^{28}\)

\(^{26}\) *But see, Bacine v. Scharffenberger*, C.A. Nos. 7862, 7866, 1984 WL 21128, Brown, C. (Del. Ch. Dec. 11, 1984) (suggesting, but not deciding, that authorization by stockholders of parent corporation would be required under Section 271 to approve merger of wholly owned subsidiary with and into another corporation if parent corporation’s stock in such subsidiary constituted “all or substantially all” of parent’s assets and was converted into another form of property in the merger).

\(^{27}\) *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (stating that “inequitable action does not become permissible simply because it is legally possible”).

\(^{28}\) In fact, that scenario would closely parallel the circumstances presented in *Hollinger*, where the plaintiff stockholder sought an injunction against a Delaware parent corporation to prevent the sale of assets by a 6th tier U.K. subsidiary. *Hollinger*, 858 A.2d at 372.
If a Delaware court issued an injunction in these circumstances, it is likely that the Court would seek to enforce the injunction by holding Conglomerate responsible if the sale moved forward. In that event, Conglomerate’s willingness (and ability) to prevent GrommetCo from effecting the transaction would be tested. Does Conglomerate have control of GrommetCo and therefore the practical ability to prevent the consummation of the transaction?

On the other hand, if GrommetCo consummates the sale before shareholders of Conglomerate object, then it may be more difficult to fashion an appropriate remedy. It is not clear, for example, how a Delaware court could enforce a judgment to unwind a transaction entered into by a non-Delaware entity. The stockholder plaintiffs might consider bringing a fiduciary duty claim against Conglomerate’s Board of Directors alleging that they breached their fiduciary duties by failing to exercise control over the subsidiary, e.g., by replacing the board of directors of GrommetCo, and prevent the disposition. In that case, however, it is not immediately clear whether such a claim would be framed as a breach of the duty of care or as a breach of the duty of good faith. However, since most Delaware corporations’ directors are exculpated from liabilities for due care violations, such a claim would be subject to a motion to dismiss. Therefore, unless the plaintiff could craft the complaint as a breach of the duty of good faith, the plaintiff may be left with little chance of recovering damages or rescinding the transaction.

Conclusion.

The Amendment provides clarity with respect to when a vote of a parent corporation’s stockholders is required in connection with the drop down of assets to, and the sale of assets by, a wholly owned and controlled subsidiary. However, a myriad of questions remains concerning the implications of the Amendment for subsidiaries that are not controlled or wholly owned by a parent corporation. In light of those questions, corporate counsel should exercise caution in advising corporations in this context pending future judicial exploration of these issues.

M&A “Nugget”

Recently, Wilson Chu, Rick Climan and Joel Greenberg participated in a webcast for DealLawyers.com that included a presentation of M&A “nuggets.” An edited transcript of one of the “nuggets” presented by Rick Climan, addressing the use of “knowledge” qualifications in public company acquisitions, is set forth below.

In acquisitions of public companies, the target company’s counsel sometimes spends a fair amount of negotiating energy attempting to insert knowledge qualifications in the target company’s representations. But interestingly enough, in the public company acquisition context, the insertion of these knowledge qualifications may make less of a difference than some practitioners think. Why is that?

Remember, in the acquisition of a public company (as distinct from the acquisition of a private company), the target company’s representations don’t survive the closing. So there is no post-closing indemnification liability for inaccuracies in those representations. Accordingly, the primary function of the target company’s representations in this context is to operate as closing conditions pursuant to the operation of the “bring down” condition. By way of reminder, the bring down condition is the provision that conditions the buyer’s obligation to close the deal on the target company’s representations being accurate as of the scheduled closing time as if those representations were re-made at that time (subject, of course, to some sort of exception for immaterial inaccuracies).

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29 See 8 Del. C. § 102(b)(7).
Consider the following simple hypothetical. Suppose the buyer includes in its draft acquisition agreement an unqualified representation on the part of the target company that the target company’s intellectual property is not subject to any material encumbrances. Assume that the target company’s lawyer pushes back and succeeds in inserting a knowledge qualification in this representation, so that the representation reads “to the target company’s knowledge, the target company’s intellectual property is not subject to any material encumbrances.” And let’s also assume that the target company had no knowledge whatsoever of any encumbrance on its IP at the time the acquisition agreement was signed.

You know what happens next – the buyer discovers a major encumbrance on the target company’s IP before closing. Does the knowledge qualification in the representation preclude the buyer from walking away? I think the answer is no. The presence of the knowledge qualification should make no difference here and the buyer should be able to walk away, just as it could if there were no knowledge qualification. Why? Because the bring down condition says that the buyer’s obligation to close is subject to the target company’s representations being accurate in all material respects at the time of the closing as if those representations were re-made at that time. And the representation in question here, which is being re-made as of the closing time, says “to the target company’s knowledge, the target company’s intellectual property is not subject to any material encumbrances.” Once the buyer tells the target company about the major encumbrance that the buyer has uncovered, that representation, even with the knowledge qualification, will be materially inaccurate at the time of the scheduled closing because the target company will have obtained knowledge of the encumbrance before the closing. Hence, the buyer should be able to walk away. And note that the buyer can walk away regardless of whether this encumbrance was already in place at the time of the signing of the acquisition agreement or arose after the signing.

Now I don’t want to suggest that the inclusion of knowledge qualifications never makes a difference in a public company acquisition agreement, because there are some situations that we can come up with where the addition of these qualifications can make a difference. But the fundamental hypothetical that I just walked through is not one of these situations. The parties’ lawyers need to understand what they’re really fighting about when they quibble over knowledge qualifications in a public company acquisition.

**TASK FORCE REPORTS**

**Task Force on Acquisitions of Public Companies**

The Task Force on Acquisitions of Public Companies met at the ABA Annual Meeting in Chicago. At the meeting, Diane Frankle led a discussion on the key drafting projects remaining for the completion of the Model Merger Agreement. A list of assignments on the various provisions in the Model Merger Agreement was compiled.

We also discussed the Voting Agreement commentary provided by Byran Davis. The Task Force discussed at length various issues and provided substantial input on the commentary. It was agreed that Delaware counsel would provide comments to the Section 203 discussion for the next draft.

Joel Greenberg led a discussion on the draft representations and warranties in the Model Merger Agreement. The members of the Task Force provided input on the introductory commentary, including a new section on Titan. The Task Force concluded that representations on certain industry-specific matters would be deleted and readers would be referred to other publications.
discussed the commentary to Section 2.13 of the Model Merger Agreement (Legal Compliance) provided by Jim Walther. In addition, Joel Greenberg discussed an additional representation that he had drafted relating to the absence of Sarbanes-Oxley Section 307 reports. Joel agreed to make additional changes to this representation based on the Task Force discussion.

We also discussed the potential scheduling of a conference call prior to year end to discuss the IP representations in the Model Merger Agreement. If you wish to participate in the conference call, please contact either of the Task Force co-chairs or Joel Greenberg.

We also planned the agenda for our Las Vegas meeting. It was agreed that we would discuss various model documents, including a model confidentiality agreement and a model exclusivity letter. We also agreed to discuss various provisions of the Model Merger Agreement, including the covenants, the representations, the conditions and the third party beneficiary provision. It was agreed that Delaware counsel would provide commentary on the representations. The Task Force co-chairs encouraged all participants to prepare drafts as early as possible before the Las Vegas meeting.

Finally, we discussed our annual Winter meeting with members of the Delaware judiciary in Wilmington, including a request by Chancellor Chandler to hold a meeting near his courthouse in Georgetown. Due to logistical and timing difficulties, however, we have decided to hold our 2006 Winter meeting in Wilmington on February 10 and 11. As in prior years, the Delaware judiciary has agreed to participate in the program with us on Saturday, February 11.

Task Force on Joint Ventures

The Task Force on Joint Ventures is pushing ahead with publishing the Model Joint Venture Agreement in a partnership format. In addition, the Task Force has two other projects: (1) “LLCing” that agreement, and (2) “internationalizing” that agreement.

In terms of LLCing the Model Joint Venture Agreement, we’re scheduled for a two hour session on Saturday, October 22, from 8:00 - 10:00 a.m. at the stand alone meeting in Las Vegas. Because we’re building on all of the work that has already been done, we only need 10 or 12 people to work on this particular project. We are currently assembling that group, but if anyone has a particular interest, please contact Tom Hyman (tom.hyman@sablaw.com). The current plan is to have one or two people read it from end to end, but also have one or two lawyers review in detail a section or group of related sections. We expect this will involve a commitment of 4 to 5 working days over the next six months.

On the “internationalizing” front, Alison Youngman is heading that up. Materials are being exchanged by the internationalizing group, but there will not be a meeting in Las Vegas.

Thomas B. Hyman, Jr.
Alison J. Youngman
Co-Chairs

SUBCOMMITTEE REPORTS

International Acquisition Transactions Subcommittee

The International Acquisition Transactions Subcommittee (formerly a task force) met in Chicago with a principal focus on the creation of a new version of the Model Asset Purchase
Agreement that can be used in jurisdictions outside the United States. At the meeting, we reviewed and commented on the markups provided of sections 3.4, 3.5 and 3.6. It was agreed that redrafts of sections 3.4, 3.5 and 3.6 would be produced and circulated prior to our next meeting in Las Vegas. In addition, Ed Kerwin agreed to provide a markup of sections 3.7 and 3.8 and Freek Jonkhart agreed to provide a markup of sections 3.9 and 3.10. All of those sections will be discussed at our stand-alone meeting in Las Vegas.

On the program front, the Subcommittee, as has been its custom, put on a program at the ABA annual meeting in Chicago. The program, which was organized by Wilson Chu was entitled “Executing Multinational Acquisitions: Trends and Techniques in Getting the Far Flung Deal Done.”

On the publications front, we have two projects slated for publication in the early part of 2006: the private company stock acquisition overview and the cross-border due diligence overview.

The meeting in Chicago was the last meeting for me as chair of the Subcommittee. It has been a pleasure and privilege to have served as chair of the Subcommittee over the last number of years. I very much appreciated the support of all members of the Subcommittee during that time and look forward to continue to work actively with all of you going forward.

John W. Leopold
Chair

Membership Subcommittee

Our Committee is now the seventh largest Business Law Section committee. Our goal by the next Annual Meeting in August is to break into the Big 5.

To help us get there, I’m delighted to announce the appointment of two new vice chairs of the Membership Subcommittee: Deborah Telman with The Boeing Company in Chicago and Hendrik Jordaan with Holme Roberts & Owen in Denver.

Remember, the most effective recruiting technique is the personal touch. So if you know of attorneys (e.g., at your office or even across the table) who would particularly enjoy active participation in our Committee, please encourage them to join us.

Wilson Chu
Chair

M&A Jurisprudence Subcommittee

The M&A Jurisprudence Subcommittee has two working groups. One is the Annual Survey Working Group, with Jon Hirschoff as chair. That group will continue the preparation and publication in The Business Lawyer of the Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions. The other working group is the Judicial Interpretations Working Group, with Jim Melville as chair. This working group will examine judicial interpretations of specific provisions of acquisition agreements and ancillary documents, looking not only for recent M&A cases of special interest, but also examining the entire body of case law on the specified type of provision. The Annual Survey Working Group will meet in Las Vegas on Saturday, October 22, from 7:30 a.m. until 9:00 a.m. The Judicial Interpretations Working Group will meet immediately thereafter, from 9:00 a.m. until 10:30a.m.

Annual Survey Working Group

The third Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions appeared in the February 2005 issue of The Business Lawyer. Our working group is now collecting 2005 cases for consideration for
inclusion in our next annual survey, which is presently scheduled to appear in the February 2006 issue of *The Business Lawyer*. We are asking all members of the Committee on Negotiated Acquisitions to send us significant judicial decisions for possible inclusion in the survey. Submissions can be sent by email either to Scott Whittaker at swhittaker@stonepigman.com or to Jon Hirschoff at jhirschoff@fdh.com. You may fax cases to Scott at (504) 596-0836 or to Jon at (203) 348-5777. Please state in your email or on the fax cover sheet why you believe the case merits inclusion in the survey.

The first criterion for inclusion is that the decision must involve a merger, an equity sale of a controlling interest, a sale of all or substantially all assets, a sale of a subsidiary or division, or a recapitalization resulting in a change of control. The second criterion is that the decision must (a) interpret or apply the provisions of an acquisition agreement or an agreement preliminary to an acquisition agreement (e.g., a letter of intent, confidentiality agreement or standstill agreement), (b) interpret or apply a state statute that governs one of the constituent entities (e.g., the Delaware General Corporation Law or the Louisiana Limited Liability Company Law), (c) pertain to a successor liability issue, or (d) decide a breach of fiduciary duty claim. We are currently excluding cases dealing with federal law, securities law, tax law, and antitrust law. However, if you feel a case dealing with an M&A transaction is particularly significant, please send it even if it does not meet the foregoing criteria.

**Decisions to be Discussed at the Las Vegas Committee Meeting**


We reported on Judge Baer’s decision denying Merrill Lynch’s motion to dismiss Allegheny’s counterclaim in this case, 2003 WL 22795650, in the Spring 2004 issue of *Deal Points*.

The case involved the sale of a commodities trading business owned by Merrill Lynch, Global Energy Markets (“GEM”), to Allegheny. Allegheny alleged that following the closing, it became aware that GEM’s CEO had employed questionable business practices, including “wash” and “round trip” energy trades, and that GEM had engaged in an allegedly fraudulent $43 million trade with a corporation owned or controlled by GEM’s CEO.

Allegheny refused to contribute certain generation assets to its newly acquired subsidiary, and Merrill Lynch brought suit, alleging that such refusal entitled it to put to Allegheny, for $115 million, a two per cent equity interest it had retained in the business. Allegheny counterclaimed for fraudulent inducement, breach of fiduciary duty, breach of contract and negligent misrepresentation.

Merrill Lynch represented in the Purchase Agreement that the information furnished to Allegheny “includes all information known to Sellers, which in their reasonable judgment exercised in good faith, is appropriate for Purchasers to evaluate the trading positions and trading operations of the Business.” On the basis of that representation, in his 2003 opinion Judge Baer distinguished cases placing the burden on the buyer to perform its due diligence and ensure that the representations cover known or readily knowable risks. For purposes of Merrill Lynch’s motion to dismiss, he concluded that the Purchase Agreement placed at least some of that burden on the seller, Merrill Lynch. He also addressed Allegheny’s allegations that Merrill Lynch’s failure to disclose the “sham” trades and problems with GEM’s CEO resulted in the breach of representations and warranties in the Purchase Agreement.

In his recent opinion and order following a bench trial, issued July 18, 2005, Judge Baer noted that on April 12, 2005 the Court granted summary judgment to Merrill Lynch on its breach of contract claim and dismissed Allegheny’s counterclaims for negligent misrepresentation and breach of fiduciary
duty. The judge also noted that the only issues left for the bench trial were the determination of the damages owed to Merrill Lynch on its breach of contract claim and the resolution of Allegheny’s breach of contract and fraudulent inducement claims.

In this opinion, Judge Baer’s primary focus was on Allegheny’s due diligence opportunities. He found that Allegheny paid $6 million over four months for the due diligence services of its financial advisor, law firm and auditor. He noted that revenues and projections provided to Allegheny were “higher than those in Merrill Lynch’s books and records . . . records one might have thought Allegheny would have sought and perused.”

Allegheny contended that a $32 million profit recognition under the Williams Contract, Allegheny’s largest single trading asset (providing a series of daily options for 18 years to call upon Williams for electricity generated from power plants in Southern California), must have been false. Judge Baer concluded that “Allegheny was never in the dark about the performance of the Williams Contract.” As a result of information provided, “Allegheny could visualize the wild fluctuations in P & L and realize the incredible difficulty in nailing down any sort of concrete value for the Williams Contract.”

Merrill Lynch eventually provided new, “updated” financial statements reflecting lower operating revenues than those in earlier financial statements. Allegheny claimed that it rejected the new financial statements and that the deal closed on the basis of the old financial data. With respect to this claim, Judge Baer’s opinion states that “this is belied by the fact that the narrative representations . . . were renegotiated at the time of signing and as a consequence of the new financials . . . . The [new] financials were thus bound behind [the Schedule relating to Business Selected Data] in the final deal documentation. . . . Allegheny did not raise much of a fuss . . . Indeed no one paid much attention to the new figures and at trial simply blamed one another for having gone along so meekly at the signature ceremony.” The opinion notes that the closing could have been postponed to investigate the lower numbers.

Judge Baer found that GEM’s CEO had evaded all of Merrill Lynch’s internal credit controls and facilitated the sale of $43 million worth of energy “outage” insurance from a make-believe company that funneled the money back to him. But he found that the fraud was perpetrated against Merrill Lynch and that Allegheny, which had never attributed any value to the insurance contract in question, could not have been harmed by the fraud.

Although Judge Baer concluded that the earlier financial information provided to Allegheny breached the Purchase Agreement representations regarding financial information, he noted that there was no claim that the updated financial information was not prepared in good faith or was not basically accurate, and that there was no evidence that Allegheny was ever denied access to any of GEM’s or Merrill Lynch’s books and records. “Any material information that Allegheny complains now was omitted was available to Allegheny and its [six] million dollar due diligence team.”

As to whether Allegheny was harmed by any alleged misrepresentations, the opinion points out that in the year after the purchase, GEM’s performance exceeded Allegheny’s expectations. Indeed, the 2001 net income projection was exceeded ten times over. “The failure of GEM the following year was not shown to be caused by any breach by Merrill Lynch.” The opinion states that Allegheny conflated proximate cause and calculation of damages by arguing that it was entitled to the difference between what it paid for GEM and what it would have paid had it known the true facts. Judge Baer concluded that it was “[m]arket forces, beginning with the collapse of Enron,” that appear to have caused the eventual harm to GEM. “It is clear that the only injury
Allegheny has proven with reasonable certainty, connected to the actions of Merrill Lynch, is a loss of face . . . .”

Finally, Judge Baer concluded that Allegheny did not justifiably rely on any representations or omissions. He cited *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 737 (2d Cir. 1984), for the proposition that “where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance.”


This opinion of the Massachusetts Superior Court was issued on cross motions for summary judgment in a case arising out of the acquisition by Kollmorgen Corporation (“Kollmorgen”) of the business of Instrument Industries, Inc. d/b/a New England Affiliated Technologies (“NEAT”). This was a sale of assets transaction, for $16,725,000 plus earn-out payments.

The issue raised by the motions for summary judgment was the appropriate interpretation of a provision in the Asset Purchase and Sale Agreement (the “Agreement”) pursuant to which the earn-out payment would be accelerated upon certain events relating to the acquired business. Specifically, the Agreement permitted Kollmorgen to sell the Assets or the Business to a third party, “provided that if at any time prior to March 31, 2001 (i) the Business is sold, (ii) all or substantially all of the Assets are sold to any third party, (iii) all or any portion of the Business is merged or consolidated without Seller’s written consent, or (iv) [either of two principals of the seller are terminated without cause,] [Buyer shall pay to Seller] an amount equal to the discounted present value of the remaining maximum earn out amount payable . . . .”

The Agreement defined the “Business” as “the business of manufacturing and selling precision machined motion control systems.” The “Assets” were defined as “all of Seller’s right, title and interest in and to all of the assets, properties, rights and contracts used in or relating to the Business wherever located, other than” certain excluded assets.

Kollmorgen was subsequently acquired by Danaher Corporation, and NEAT became a division, or part of a division, of Danaher. NEAT made its target for earn-out payments for the first two years. However, after NEAT failed to do so in the third year, Danaher “brought in” a European subsidiary to operate “in conjunction with NEAT,” and (just before the expiration of the earn-out period), Danaher acquired assets in a bankruptcy sale and began using those assets in the NEAT operation.

The plaintiff argued that the steps taken by Danaher to bring in its European subsidiary and to use the assets acquired in the bankruptcy sale in the NEAT business resulted in a merger or consolidation of the Business. Danaher argued that the meanings of “merger” and “consolidation” should be restricted to their meaning in the business world.

The Court found the Agreement ambiguous as to whether the earn-out for the third year was triggered, and concluded that it would therefore be necessary to look to extrinsic evidence to resolve the issue as to the proper interpretation of the Agreement.

Noting that the Table of Contents to the Agreement contained a Definitions section with citations to 106 definitions, there was nonetheless no definition of “merger” or “consolidate,” the Court concluded: “Thus, ordinary dictionary definitions will have to suffice.”

As to Danaher’s contention that more formal usage, as used in the corporate sense, should
be applied, the Court noted that “here the Agreement is not dealing with a corporation. What the ‘Business’ is, is the use and application of assets acquired from a corporation known as NEAT, which assets were purchased by Danaher’s predecessor Kollmorgen.”

An affidavit of the attorney who represented NEAT did not explain why the words “merger” and “consolidate” were used when only NEAT’s assets were sold.

The Court thought it “obvious that in order for the earn-out provisions to be fair to both NEAT and Danaher, the assets and the use of those assets acquired from NEAT should be kept and used without any significant addition or subtraction of or to those assets during the earn-out period.”

Finally, the Court concluded that the extrinsic evidence provided in the parties’ motion papers did not provide the answers needed to interpret the Agreement, and that summary judgment was therefore inappropriate.

Judicial Interpretations Working Group

The second meeting of the Judicial Interpretations Working Group was held at the ABA Annual Meeting in Chicago. We were very pleased by the growing participation in the working group. Teams have been formed to research and prepare memoranda pertaining to the jurisprudence interpreting twenty different provisions of M&A agreements and ancillary documents. We have many more projects we would like to undertake, and we invite any additional members of the Committee to participate in this new working group. To join, please send an email to Jim Melville at jcm@kskpa.com, with a copy to Scott Whittaker at swittaker@stonepigman.com, or just come to our working group meeting in Las Vegas.

At our working group meeting in Las Vegas, we will discuss the work product of those teams that have made significant progress on their projects, form teams of new members and discuss and assign new projects.

Scott Whittaker
Subcommittee Chair

Jon T. Hirschoff
Annual Survey Working Group Head

James C. Melville
Judicial Interpretations Working Group Head

M&A Market Trends Subcommittee

The M&A Market Trends Subcommittee continues to make considerable progress in its first year with its two initial projects to publish studies containing critical statistical and other information regarding key negotiated deal points involving (i) public buyers/private targets, and (ii) public buyers/public targets. After recently having completed the data gathering process, we are now conducting quality control reviews and assimilating the statistical information into various graph formats. With any luck, the results of this year’s studies will be available in the next month or two. In Las Vegas, we will consider additions and modifications to the various issues and data points to be analyzed in future deal points studies.

In addition to the Public/Public Study, vice chair Keith Flaum (flaumka@cooley.com) continues to lead the effort to beta test an M&A Market Check Message Board on which M&A professionals can post questions, canvass the market and engage in a dialogue regarding current M&A practice. Anyone interested in joining our Subcommittee can contact either of the co-chairs, Wilson Chu (Wilson.Chu@HaynesBoone.com) and Larry Glasgow (lglasgow@gardere.com).

Wilson Chu
Lawrence Glasgow
Co-Chairs
Programs Subcommittee

Following the full Committee meeting in Las Vegas on Saturday, October 21, a panel consisting of The Honorable Myron T. Steele, Chief Justice of the Delaware Supreme Court, Mark Morton and Rick Alexander will present a Committee forum entitled “A Primer on Appraisal Rights for the M&A Lawyer.” The panel will review the “ins” and “outs” of Delaware’s appraisal statute and will address issues that should be considered by the M&A lawyer, including the scope of disclosure that is required, valuation issues posed by an appraisal, the increasing interest of hedge funds in the appraisal remedy and the (f)utility of exercising appraisal rights when it is the only alternative to accepting the merger consideration.

Thomas M. Thompson
Chair

Committee Forum Materials

Immediately after the full Committee meeting on Saturday, October 22, a Committee Forum presentation titled “A Primer on Appraisal Rights for the M&A Lawyer” will be held featuring The Honorable Myron T. Steele, Chief Justice of the Delaware Supreme Court. In connection with the Committee Forum, Rick Alexander and Angie Priest have contributed a “nuts and bolts” outline on Delaware Appraisal Basics, while Mark Morton and Roxanne Houtman have written an article entitled “The Duty of Disclosure and Appraisal: Say What?” Copies of the Committee Forum materials are set forth below.

Delaware Appraisal Basics

Frederick H. Alexander
Angela L. Priest
Morris, Nichols, Arsht & Tunnell

I. The Availability Of Appraisal Rights

A. Mergers and Consolidations: With some exceptions, appraisal rights are available to stockholders of constituent corporations in mergers and consolidations effected pursuant to Sections 251, 252, 253, 254, 257, 258 or 263 of the Delaware General Corporation Law (the “DGCL”). 8 Del. C. § 262(b).

B. Other Transactions: A corporation’s certificate of incorporation may also provide for appraisal rights for shares of any class or series of stock following an amendment to the certificate of incorporation, a sale of all or substantially all of the assets of the corporation, or any merger or consolidation in which appraisal rights would not otherwise be available. 8 Del. C. § 262(c).

C. Section 262 Applies Without Regard to Voting Rights: Appraisal rights are generally available to all stockholders, whether or not their shares are entitled to vote on the merger.

D. Section 251(f): Section 262 denies appraisal rights for stockholders of the constituent corporation surviving the merger if their vote was not required to approve the merger under Section 251(f). 8 Del. C. § 262(b)(1). As a general matter, Section 251(f) eliminates the requirement of approval of a merger by the stockholders of a surviving corporation if the outstanding shares and charter of the surviving corporation are unaffected by the merger, and if the surviving corporation issues 20% or less of its shares in connection with the merger. 8 Del. C. § 251(f).
**E. Section 253 Short-Form Merger’s:**

Appraisal rights are not available to the stockholders of a parent corporation in a short-form merger. 8 Del. C. § 253.

**F. Section 251(g) Holding Company Mergers:**

Appraisal rights are not available in holding company mergers accomplished pursuant to Section 251(g). Section 251(g) allows a corporation to effect a merger to create a holding company structure without a stockholder vote if a somewhat complex set of provisions, intended to protect stockholder rights, is satisfied. 8 Del. C. § 251(g).

**G. Market Out:**

Section 262 begins with the premise that appraisal rights exist for the shares of each class or series of stock of each constituent corporation. The statute then denies appraisal rights if the corporation’s shares qualify for the “market out.”

1. **Double Test:**

   a. **Part One.** Section 262 denies appraisal rights to shares of a class or series that, as of the record date fixed for the vote on the merger, are:

      (1) listed on a national securities exchange;

      (2) designated as a National Market System Security (“NMS”) or an interdealer quotation system by the National Association of Securities Dealers, Inc. (“NASDAQ”); or

      (3) held of record by more than 2,000 stockholders (multiple owners holding through a single record owner should not be counted in applying the 2,000 stockholder limit).

   b. **Part Two.** Even if the market out would otherwise apply, the statute reinstates appraisal rights if the holders are required to accept cash or other consideration in the merger other than:

      (1) shares of stock of the surviving corporation;

      (2) shares of stock that at the effective date of the merger (not the record date) are:

      a. listed on a national securities exchange;

      b. listed on NASDAQ/NMS; or

      c. held by record of more than 2,000 stockholders;

      (3) or cash in lieu of fractional shares. 8 Del. C. § 262(b)(2)(a)-(d).

2. **Exception to the Market Out:**

   a. **Short-Form Mergers Under Section 253.** The market out does not apply to short-form mergers accomplished pursuant to Section 253 of the DGCL. In a short-form merger, the shares of the parent corporation have no appraisal rights, and the shares of the subsidiary have appraisal rights if the parent owns less than all of the subsidiary’s stock, regardless of the number of record holders or the nature of the merger consideration.

**II. Who May Seek Appraisal**

**A. General Rule:** The right to pursue appraisal extends to any stockholder of record who: (1) owns shares of stock on the date that the stockholder demands appraisal; (2) continues to hold the shares through the effective date of the merger or consolidation; and (3) neither votes in favor of the merger or consolidation nor executes a written consent in favor of the transaction. 8 Del. C. § 262(a).

**B. Stockholders of Record:** Only stockholders of record are entitled to pursue appraisal rights. Beneficial owners and holders of stock options therefore lack standing to pursue an appraisal. See, e.g., *Aspen Advisors LLC v. United Artists Theatre*
C. Shares Acquired After the Merger is Announced or Post-Record Date: Stockholders who purchase stock after the announcement of a merger and stockholders who become stockholders of record after the record date for the merger or consolidation are not disqualified from pursuing appraisal if the other statutory requirements are met. Salomon Bros. v. Interstate Bakeries Corp., 576 A.2d 650 (Del. Ch. 1989). However, if shares are voted in favor of the merger and then sold, it is not clear whether the new holder would have appraisal rights.

D. Stockholders Who Dispose of Shares Between the Date of Demand and the Effective Date of the Merger or Consolidation Do Not Have Appraisal Rights: Because the statute requires stockholders to hold their shares continuously through the period following the date of demand until the effective date, any stockholder that was a record holder as of the date of demand but sold his or her shares only to reacquire other shares so as to become a stockholder of record on the effective date will not be entitled to appraisal. R. Franklin Balotti & Jesse A Finkelstein, The Delaware Law of Corporations and Business Organizations, § 9.43[B] (3d ed. 2005).

E. “Hedging”:

1. A stockholder of record holding shares for more than one beneficial owner may vote some shares in favor of a merger and seek appraisal for others. Reynolds Metals Co. v. Colonial Realty Corp., 190 A.2d 752 (Del. 1963).


3. In one case involving a long-form merger, the Court of Chancery permitted a stockholder who voted all of his shares against the merger and demanded appraisal to withdraw the demand and accept the merger price as to some (but not all) of his shares, as long as all the shares held by such owner (who was also the record owner) were voted against the merger. The Union Illinois 1995 Inv. Ltd. P’ship v. Union Fin. Group, Ltd., 847 A.2d 340 (Del. Ch. 2003).

F. Stockholders Who Vote in Favor of the Merger or Consolidation Do Not Have Appraisal Rights:

1. Stockholders need not vote against the proposed transaction as long as they did not vote for it. Engel v. Magnavox Co., C.A. No. 4896 (Del. Ch. Apr. 22, 1976).

2. Any proxy previously submitted in favor of the proposed transaction must be effectively revoked before a demand for appraisal may be made. See Moffit v. Wellington Management Co., C.A. No. 6108 (Del. Ch. Apr. 8, 1981).

3. It is unclear under Delaware law whether consents voted pursuant to Section 228 in favor of a merger or consolidation that are delivered after approval of the transaction constitute a vote in favor of the transaction. It could be argued that once sufficient consents are delivered, the vote has been concluded, and thus the later delivered consents do not amount to a waiver of appraisal rights. 8 Del. C. § 228.

G. Withdrawal: A stockholder who properly demands appraisal may withdraw the demand as follows:

1. At any time within 60 days of the effective date of the merger, the stockholder may...
withdraw his or her demand unilaterally. 8 Del. C. § 262(e).

2. After the period of 60 days following the effective date of the merger has passed but before the petition for appraisal is filed, the stockholder can only withdraw his or her demand for appraisal with the written consent of the surviving corporation. 8 Del. C. § 262(k).

3. After the petition for appraisal has been filed, a stockholder can only withdraw his or her demand for appraisal with court approval. 8 Del. C. § 262(k).

4. Dismissal will not be granted by the court if 60 days have passed after the effective date and the surviving corporation opposes dismissal. 8 Del. C. § 262(k). See Salomon Bros., Inc. v. Interstate Brands Corp., C.A. No. 10054 (Del. Ch. July 12, 1991).

III. Required Filings, Notices, And Demands

A. Notice of Appraisal Rights and the Effective Date:

1. For Mergers Approved at a Stockholder Meeting:

a. Notice of Appraisal Rights. The corporation must notify all stockholders that were stockholders on the record date of the meeting for which appraisal rights are available of the availability of appraisal rights, and such notice must include a copy of Section 262. See Nebel v. Southwestern Bancorp., Inc., C.A. No. 13618 (Del. Ch. Mar. 9, 1999) (finding that the erroneous inclusion of a page from another state’s appraisal statute in the notice of appraisal rights was a material misdisclosure and substantive statutory violation for which a quasi-appraisal was the appropriate remedy). Such notice must be sent not less than 20 days prior to the meeting. 8 Del. C. § 262(d)(1). See also Jackson v. Turnbull, C.A. No. 13042 (Del. Ch. Feb. 8, 1994), aff’d, 653 A.2d 506 (Del. 1994) (holding that a corporation may not vary the statutory time periods set forth in Section 262, where corporation stated in notice that a stockholder’s demand and petition for appraisal must be made within 20 and 120 days, respectively, following the mailing of a valuation).

b. Stockholder Demand. Each stockholder demanding appraisal must deliver a written demand for appraisal to the corporation before the vote on the merger or consolidation is taken. A proxy or vote against the transaction will not constitute a demand. 8 Del. C. § 262(d)(1).

c. Notice of Effective Date. Within 10 days after the effective date of such merger or consolidation, the surviving or resulting corporation must notify each stockholder that properly demanded appraisal under Section 262 of the effective date of the merger or consolidation. 8 Del. C. § 262(d)(1).

2. For Mergers Approved by Written Consent or Under the Short-Form Provisions of Section 253:

a. Notice of Appraisal Rights. Notice of appraisal rights must be given to each of the holders of any class or series of such constituent corporation who are entitled to appraisal rights.

   (1) Such notice may be given by the constituent corporation before the effective date of the merger to all stockholders entitled to appraisal rights on the record date fixed by the corporation. Such notice should state that the merger or consolidation was approved and that appraisal rights are available, and shall include a copy of Section 262. 8 Del. C. § 262(d)(2).

   (2) Such notice may be given by the surviving corporation within 10 days after the effective date of the merger to all stockholders entitled to appraisal rights as of the effective date, and must state that the merger or consolidation was approved, provide the effective date of the transaction, state that appraisal rights are available,
and include a copy of Section 262. 8 Del. C. § 262(d)(2).

b. Stockholder Demand. Any stockholder entitled to appraisal rights may, within 20 days after the mailing by the corporation of the notice of appraisal rights, demand appraisal of such holder’s shares in writing. 8 Del. C. § 262(d)(2).

c. Notice of Effective Date. If the notice of appraisal rights did not notify stockholders of the effective date of the merger or consolidation, either (1) each such constituent corporation shall send a second notice before the effective date of the merger or consolidation notifying each of the holders of any class or series of stock of such constituent corporation that are entitled to appraisal rights of the effective date of the merger or consolidation; or (2) the surviving or resulting corporation shall send such a second notice to all such holders on or within 10 days after such effective date. If such second notice is sent more than 20 days following the sending of the first notice, such second notice need only be sent to each stockholder who is entitled to appraisal rights and who has demanded appraisal of such holder’s shares in accordance with Section 262(d)(2). 8 Del. C. § 262(d)(2).

d. Record Date. For the purpose of determining the stockholders entitled to receive either the first or second notice, each constituent corporation may fix a record date that shall not be more than 10 days prior to the date notice is given, provided that if the notice is given on or after the effective date of the merger or consolidation, the record date shall be such effective date. If no record date is fixed and the notice is given prior to the effective date, the record date shall be the close of business on the day next preceding the day on which the notice is given. 8 Del. C. § 262(d)(2).

B. Section 262(e) Notice: Within 120 days after the effective date of the merger or consolidation, any stockholder who has complied with Section 262 shall, upon written request, be entitled to receive from the corporation surviving the merger or resulting from the consolidation a statement setting forth the aggregate number of shares not voted in favor of the merger or consolidation and with respect to which demands for appraisal have been received and the aggregate number of holders of such shares. Such written statement shall be mailed to the stockholder within 10 days after such stockholder’s written request is received by the corporation or within 10 days after expiration of the period for delivery of demands for appraisal under Section 262(d), whichever is later. 8 Del. C. § 262(e).

C. Filing of Petition For Appraisal: Within 120 days after the effective date of the merger or consolidation, the surviving or resulting corporation or any stockholder who has complied with Section 262 may file a petition in the Court of Chancery demanding a determination of the value of the stock of all such stockholders. 8 Del. C. § 262(e).

D. Section 262(f) Verified List Filing:

1. Procedure if a Stockholder Files the Petition For Appraisal. Upon the filing of any petition by a stockholder, service of a copy thereof shall be made upon the surviving or resulting corporation, which surviving or resulting corporation shall, within 20 days after such service, file in the office of the Register in Chancery in which the petition was filed a duly verified list containing the names and addresses of all stockholders who have demanded payment for their shares and with whom agreements as to the value of their shares have not been reached by the surviving or resulting corporation. 8 Del. C. § 262(f).

2. Procedure if the Surviving or Resulting Corporation Files the Petition for Appraisal. The duly verified list containing the names and addresses of all stockholders who have demanded appraisal for their shares and with whom agreements as to the value of their shares have not been reached by the surviving or resulting
corporation shall accompany the petition. 8 Del. C. § 262(f).

E. Notice by the Register in Chancery: If so ordered by the Court, the Register in Chancery shall give notice of the time and place fixed for the hearing of such petition by registered or certified mail to the surviving or resulting corporation and to the stockholders set forth in the duly verified list. Such notice shall also be given by 1 or more publications at least 1 week before the day of the hearing, in a newspaper of general circulation published in Wilmington, Delaware or such publication as the Court deems advisable. The forms of the notices must be approved by the Court and the costs of such notices must be borne by the surviving or resulting corporation. 8 Del. C. § 262(f).

IV. Content Of Notices

A. Contents of Notice of Appraisal Rights: The notice of appraisal must contain: (1) a statement making known the availability of appraisal rights; (2) a copy of Section 262; (3) instructions regarding how to perfect appraisal rights (under Delaware case law, minimally, it is advisable to inform stockholders that a demand for appraisal must be made by or on behalf of the holder of record, as such holder is identified on the records of the corporation). See Enstar Corp. v. Senouf, 535 A.2d 1351 (Del. 1987); and (4) information material to the stockholder’s decision to accept the merger consideration or demand appraisal (see Section V below for a discussion of the duty of disclosure). 8 Del. C. § 262(d).

B. Contents of Notice of Effective Date: The notice of effective date must notify the stockholders entitled to appraisal of the effective date of the merger or consolidation. 8 Del. C. § 262(d).

C. Contents of 262(e) Notice: This notice must contain a statement setting forth the aggregate number of shares not voted in favor of the merger or consolidation and with respect to which demands for appraisal have been received and the aggregate number of holders of such shares.

V. Fiduciary Duty of Disclosure

A. Duty of Disclosure:

1. Directors “have a fiduciary duty to disclose to the shareholders the available material facts that would enable them to make an informed decision, pre-merger, whether to accept the merger consideration or demand appraisal.” Turner v. Bernstein, C.A. No. 16190 (Del. Ch. Feb. 9, 1999), slip op. at 15-16 (citations omitted).


4. The Court of Chancery has held that a limited form of quasi-appraisal was the appropriate remedy for incomplete disclosure in a notice of a short-form merger. Gilliland v. Motorola, Inc., C.A. No. 411-N (Del. Ch. Mar. 4, 2005), slip op. at 12.

B. Duty of Disclosure in a Short-Form Merger: The Court of Chancery has held that even if disclosure was made in connection with a tender offer in a two-step transaction and remains publicly available, the notice of appraisal following the second step short-form merger should include summary financial information and instructions as to how to obtain more detailed information. Gilliland v. Motorola, Inc., C.A. No. 411-N (Del. Ch. October 8, 2004).
The Duty of Disclosure and Appraisal: Say What?

Mark A. Morton
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In connection with a merger that triggers appraisal rights, directors of Delaware corporations are subject to two parallel duties of disclosure: one grounded in the appraisal statute, 8 Del. C. § 262, and the other grounded in common law fiduciary duties. With respect to the former, Section 262(d)(1)-(2) requires that a corporation notify shareholders of the right to seek an appraisal and of the merger’s effective date. As part of fulfilling this statutory duty, the corporation is required to provide shareholders with a copy of the appraisal statute.

More importantly, directors of a Delaware corporation owe shareholders a fiduciary duty of disclosure. This duty flows from the triad of fiduciary duties of care, loyalty and good faith. Pursuant to the duty of disclosure, directors are required to “disclose fully and fairly all material information within the Board’s control.”

What is less clear, however, is the nature and extent of the information that directors must give shareholders when presenting them with the option of accepting the merger consideration or perfecting a demand for appraisal. The Delaware Supreme Court has indicated only that “[w]here the only choice for the minority stockholders is whether to accept the merger consideration or seek appraisal, they must be given all the factual information that is material to that decision.” The Court has not, however, clearly specified what factual and financial information should be given to shareholders.

One of the earliest cases to address the adequacy of appraisal disclosure was Shell Petroleum, Inc. v. Smith. In connection with a short-form merger, the defendant-majority shareholder submitted to minority shareholders a discounted cash flow analysis that understated future net cash flow by approximately $1 billion. The Supreme Court held that the majority shareholder “bears the burden of showing complete disclosure of all material facts relevant to the minority shareholders’ decision whether to accept the short-form merger consideration or seek appraisal.”

Adopting the federal standard of “materiality,” the Court stated that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered fully and fairly all material information within the board’s control when it seeks shareholder action”.

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2 8 Del. C. § 262(d)(1).


4 Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1172 (Del. 2000). See also Turner v. Bernstein, C.A. No. 16190 (Del. Ch. Feb. 9, 1999), slip op. at 15-16 (stating that the duty of disclosure “flows from the broader fiduciary duties of care and loyalty [and] is triggered where directors . . . present to stockholders for their consideration a transaction that requires them to cast a vote and/or make an investment decision, such as whether or not to accept a merger or demand appraisal”).

5 Malone v. Brincat, 772 A.2d 5, 10 (Del. 1998). See also, Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (“Directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board’s control when it seeks shareholder action”).


7 606 A.2d 112 (Del. 1992).

8 Id. at 114.

9 Id. (citing Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 846 (Del. 1987)).
the ‘total mix’ of information made available.”¹⁰ In Shell, the Court found the $1 billion difference both highly relevant and material to the minority shareholders’ decision.¹¹ Accordingly, the Court held that the defendant breached its fiduciary duty of disclosure.¹²

Nearly eight years later, the Delaware Supreme Court further elaborated on its earlier decision in Shell when it issued its decision in Skeen v. Jo-Ann Stores, Inc.¹³ In that case, plaintiff-shareholders unsuccessfully alleged that specific information pertaining to a target company’s valuation was needed to make an informed decision as to whether to accept the merger consideration or seek judicial remedies.¹⁴ The court rejected the shareholders argument that minority shareholders are entitled to receive all of the financial information necessary to make an “independent determination of fair value.”¹⁵ Moreover, the court declined to adopt a new standard whereby directors and controlling shareholders would be subject to a more exacting duty of disclosure when appraisal rights are at issue.¹⁶ In Skeen, the court found that the defendant company had provided the minority shareholders with the basic, relevant financials, thus satisfying its fiduciary duty of disclosure.¹⁷

Duties of Disclosure of Private Companies: No Diluted Duties

The fiduciary duty of disclosure applies equally to directors of public and private companies. In Erickson v. Centennial Beauregard Cellular, L.L.C., the Court of Chancery refused to draw distinctions between the levels of disclosure required by a public company and that required by a private company.¹⁸ In Erickson, the plaintiff was a shareholder in a small private company, which was merged into its parent company via a short-form merger.¹⁹ The parent company sent the fourteen minority shareholders of the subsidiary a two-page document purporting to detail the value of the company, but the parent company failed to provide shareholders with basic financial statements.²⁰

In considering the plaintiff’s objections, the court first noted the dilemma that exists for all investors in a private company - “[plaintiff]-stockholder had no objective market data upon which to measure the fairness of the proposed merger consideration.”²¹ Moreover, the Court noted, shareholders in private companies do not always possess the same level of access to general information about their companies, as shareholders of public companies may have.²² In particular, the court remarked that the minority shareholders in the

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¹⁰ Id. (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).
¹¹ Id. at 115.
¹² Id.
¹³ 750 A.2d 1170 (Del. 2000).
¹⁴ Id. at 1172. Minority shareholders were provided with the company’s audited and unaudited financial statements, the investment banker’s fairness opinion, and the company’s quarterly market prices. Id. at 1173. Plaintiffs argued that in addition to the foregoing, they were entitled to summary information about the methodologies employed by the investment bankers and management’s 5-year projected performance. Id.
¹⁵ Id. at 1174. The Court of Chancery remarked that “[o]mitted facts are not material simply because they might be helpful. To be actionable, there must be a substantial likelihood that the undisclosed information would significantly alter the total mix of information already provided.” Id. (emphasis added).
¹⁶ Id. at 1171.
¹⁷ The Court noted that to successfully assert a breach of fiduciary duty claim, plaintiffs must “‘allege that facts are missing from the information statement, identify those facts, state why they meet the materiality standard and how the omission caused injury.’” Id. at 1173 (citing Louden v. Archer-Daniels-Midland Co., 700 A.2d 135, 140 (Del. 1997)).
¹⁹ Id. at *1.
²⁰ Id.
²¹ Id. at *6.
²² Id. at *7.
instant case “had no way of knowing what the company’s operations were and, as a result, may not have even a rudimentary understanding of [the company’s] products or services.” In that setting, the court concluded that defendants’ failure to provide such information constituted a breach of the fiduciary duty of disclosure. In doing so, the Court demonstrated an unwillingness to dilute the disclosure requirements for private companies and signaled that it may require the disclosure of additional material where private company shareholders are unable to locate such information publicly.

The Erickson decision is also important for the insight it offers into what the Delaware Court of Chancery considers minimum levels of required disclosure for both public and private companies. Specifically, the Court commented on four areas where disclosure of factual and financial information will aid the shareholder in making an informed decision regarding appraisal rights.

1. Current and Historical Financial Statements

In Erickson, the company provided minority shareholders with two valuation methods: recent transaction and discounted cash flow analysis. The court observed, however, that both analyses were based on a single calculation, earnings before interest, tax, depreciation and amortization (EBITDA). The company did not include any financial statements, or other comparable reports which would allow the shareholders to perform their own analysis. Chancellor Chandler commented that the company failed to provide “information . . . related to the company’s revenue streams, levels of working capital, or any other financial information that would permit a stockholder to perform even the most basic financial ratio analysis.”

2. Description of the Company’s Business and Prospects

The defendants in Erickson also failed to provide shareholders with any information pertaining to the company’s business, operations or plans for the future. The court stated that “some indication of business revenue projections is . . . necessary for shareholders to determine whether they are receiving a fair price for their shares.” The court also rejected the defendant’s argument that, because it supplied plaintiffs with the discounted cash flow analysis, plaintiffs were alerted to the company’s projections. Chancellor Chandler reasoned that “stockholders should not have to perform sophisticated financial calculations, derived from cash flow analyses provided without any underlying information, in order to figure out management’s view of the company’s future business.”

3. Industry Specific Valuation Metrics

Ordinarily, minority shareholders are not entitled to receive disclosure pertaining to “every conceivable methodology to value their shares.” In this case, however, the plaintiff argued that one particular methodology, the “per-pop” valuation, the cellular industry standard, should have been

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23 Id.
24 Id.
25 Id. at ** 6-9.
26 Id.
27 Id. at *1.
28 Id.
29 Id. at *6.
30 Id.
31 Id. at *7.
32 Id.
33 Id.
34 Id.
35 Id. at *8.
made available to shareholders. Plaintiff argued, and the court agreed, that the information by which the industry standard valuation method could be calculated should have been made available to shareholders, even if the valuation itself was not. Although the information was publicly available, the company had failed to inform shareholders of the manner in which they could obtain said information. In fact, the court determined that the shareholders “likely had no reason to know the information was available.” In reaching this conclusion, the Court signaled that if there is a standard valuation method for a particular industry then the company should disclose the information necessary to perform the valuation.

4. Valuation Data and Background

While the court did not specifically indicate the extent of the valuation data that is to be made available to minority shareholders, Chancellor Chandler declared that use of a single number or value which “purports to encompass the value of [a company], not supported with any financial information . . . is simply not sufficient, as a matter of law.” Chancellor Chandler explained that additional information and clarification is needed, “including the derivation of revenues, allocation of expenses, [and the] basis for selecting the []multiple [used].” In Erickson, the court found that the “valuation analysis presented to []stockholders was so bereft of actual information that, while all of the requested information may not have been required, defendants had a duty to provide at least some further indication of the company’s value to its stockholders.” Thus, it is clear that the disclosure provided by directors (and/or majority shareholders) must include financial data that will allow shareholders to acquire an accurate sense of the company’s value before they decide whether to accept the proposed merger consideration or demand appraisal rights.

Gilliand v. Motorola, Inc.: Minimum Disclosures in a Short Form Merger

In 2004, the Delaware Court of Chancery addressed disclosure requirements in a going-private transaction. The basic obligations are the same: compliance with statutory requirements and with the fiduciary duty of disclosure, which the Court described as the duty to “provide substantive, financial information relating to the value of the company.” The issue in Gilliand, however, was whether the fiduciary duty of disclosure can be satisfied solely “by implicit reference to the ‘total mix’ of information disseminated in connection with a contemporaneously concluded tender offer.”

In an earlier Delaware Supreme Court decision, Zirn v. VLI Corporation, the Supreme Court recognized that short-form mergers effectuated under Section 253 are “essentially summary procedure,” and that the requisite notice is intended primarily to inform shareholders of the actions taken and their right to seek an appraisal remedy. The Zirn court found that because the defendant corporation had made substantial

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36 Id.
37 Id.
38 Id.
39 Id.
40 Id. at *9.
41 Id.
42 Id. See also Nagy v. Bistricer, 770 A.2d 43, 60 (Del. Ch. 2000) (finding that directors of the controlling stockholder breached their fiduciary duty of disclosure when they failed to provide a minority shareholder with, inter alia, financial and valuation information about the target and acquiring company).
44 Id. at 86.
45 Id.
46 681 A.2d 1050, 1059 (Del. 1996).
disclosure at the time of the tender offer, and because the parties had negotiated the transaction at arms length, the company could provide minority shareholders with a less detailed disclosure. However, while the Court did not require “voluminous” additional disclosure, it is worth noting that the defendant had provided minority shareholders with high/low bid quotes for the previous two years, summary financial information for the preceding five years, and instructions on where to find more complete SEC filings.

As in Zirn, both the acquiring and target companies in Gilliland made substantial disclosure to minority shareholders during the first-step tender offer. Consequently, the court concluded that Motorola was not required to send voluminous disclosure with the notice of merger. In Gilliland, however, the notice supplied by the acquiror, Motorola, provided notice only of the merger and the effective date. The defendant argued that this minimum level of disclosure was sufficient, as more extensive financial disclosure had been made in the course of the recently completed tender offer. Further, Motorola pointed to various public documents, such as the target company’s Form 10-K and other SEC filings, that contained the information plaintiffs alleged they should have been given.

The Court observed, however, that Motorola’s notice did not direct shareholders to the location where such public information could be obtained, and the manner in which it could be obtained. The Court also noted that, notwithstanding the fact that the information may be widely available to the public, “it will always be a simple exercise to identify the relevant disclosure documents, and either include them in the notice, or extract and disclose summary information from them, and advise stockholder how to obtain more complete information.” Thus, “a notice given pursuant to section 262 must contain, at a minimum, summary financial and trading data and reference to the publicly available sources from which more complete information is available.”

**Conclusion**

Based upon the foregoing, it is apparent that in connection with a merger for which appraisal rights are available the fiduciary duty of disclosure requires that directors and majority shareholders provide minority shareholders with substantive financial and factual information. The information disclosed must be sufficient to permit shareholders to make an informed decision as to whether to accept the proposed merger consideration or seek the judicial remedy of appraisal. While the Delaware courts have not explicitly stated what documents should be included with the notice of merger, the aforementioned cases, namely Erickson, shed some light on the kinds of documents that should be disclosed. In particular, the following

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47 Id. The Court distinguished the nature of the transaction in Zirn from uncontested corporate self-tenders and cash-out mergers where “disclosure to shareholders is normally one-sided.” Id. The Supreme Court noted that because the parties in Zirn negotiated the transaction at arms-length and both sides presented the shareholders with information during the tender offer stage, the “specter of intentional misinformation” was absent, and “voluminous disclosure” was not necessary. Id.

48 Id. at 1060.

49 Gilliland, 859 A.2d at 87. The court also noted that the acquiring company showed “fierce resistance” to Motorola’s tender offer, which resulted in “a level of disclosure at least equal to that found in a typical negotiated third-party acquisition.” Id.

50 Id. at 88.

51 Id. at 83.

52 Id. at 86-87.

53 Id.

54 Id. at 88.

55 Id. The Court added that “[i]n view of the modest cost of providing such information, a majority stockholder’s fiduciary duty requires that such information be furnished in the notice of merger.”

56 Id.
documentation should be included with the Section 262 notice:

- Current and historical financial statements or comparable reports that will allow shareholders to calculate basic financial ratios.

- Information describing the company’s current business and operations, and business revenue projections.

- Information relating to industry-specific valuation metrics and/or details on where to locate and obtain such information if available within the public sphere.

- Substantive valuation data, and background information supporting the valuation information.

Where appraisal rights arise as a result of a negotiated tender offer and prompt short-form merger, the Court of Chancery has indicated that the requisite disclosures should include summary financial and trading information, reference to relevant disclosure documents and directions on how the shareholder can locate and obtain copies of information available from public sources.