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Tender Offers: Recent Guidance on the Use of Top-Up Options

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Speed. Certainty. Parties to friendly acquisitions, once a price has been agreed, want to get their deals done without delay and without deal execution risk. That's why deals structured as first step tender offers followed by second-step mergers using "top-up options" have become so popular.[1] Not surprisingly, as the popularity of top-up options has increased, so too has the frequency of lawsuits being brought against their use.[2] This renewed focus on the validity of top-up options provided the Delaware Chancery Court with the opportunity to offer strong guidance in this area on February 21, 2011 in the *Olson v. ev3, Inc.*[3] decision (hereinafter "*Olson*").

Top-Up Options

A typical top-up option provision permits the buyer to acquire authorized and unissued shares of the target's stock for the same purchase price as the tender offer price and is usually exercisable only if a certain minimum threshold number of shares are tendered into the offer. The option exercise, when combined with the stock acquired in the tender offer, enables the buyer to obtain more than 90 percent of the target's stock so that a second-step merger can be completed as a short-form merger under Section 253 of the Delaware General Corporation Law (the "DGCL")[4] (rather than as a long-form merger under DGCL Section 251)[5] without the need for a shareholder vote or meeting.

Prior Case Law

Prior to 2010 there was very little Delaware authority on the use of top-up options, with the Delaware cases mentioning the issue arising in the context of two transcript rulings, each on a motion to expedite.[6] Then, throughout 2010, the Delaware Court of Chancery rejected several shareholder challenges to top-up option provisions, including shareholder claims that: top-up options were "sham" transactions because any note issued by the buyer to pay the exercise price would be payable to a company that would become a wholly-owned subsidiary of the buyer soon thereafter; the tender offer documents contained insufficient disclosure; and the issuance of additional shares under a top-up option provision in a merger agreement and the value of any promissory note delivered in exchange for such shares would impact negatively on a non-tendering shareholder's appraisal rights by diluting the company's value (the so-called "appraisal dilution" argument).[7]

In denying plaintiffs' motion to preliminarily enjoin 3M's acquisition of Cogent, Vice Chancellor Parsons concluded that: Cogent's board had properly authorized the top-up option; the use of a promissory

note to pay the option exercise price did not make the option a sham transaction; and the merger agreement's express language excluding any shares issued under the top-up option from any appraisal calculation was effective and, therefore, the plaintiffs were unlikely to prevail on their appraisal dilution claim.[8]

In *In re Protection One, Inc. Shareholders Litigation,* Vice Chancellor Strine focused on a separate theory to reject an appraisal dilution claim, expressing the view that the issuance of shares under a top-up option should be viewed merely as part of the accomplishment of the merger and thus excluded from any appraisal proceeding by operation of Delaware's appraisal statute.[9]

Olson v. ev3, Inc.

In his 31-page *Olson* memorandum opinion, Vice Chancellor Laster provided substantial guidance on the use of top-up options in two-step acquisitions. This opinion was issued in connection with a contested fee application following approval of a settlement. Since the litigation was settled, the Court analyzed the strength of the plaintiff's top-up option claims to determine the benefit achieved in the context of determining the size of an award of attorney's fees.[10]

By way of background, ev3, Inc. ("ev3") had agreed to be acquired by Covidien Group S.a.r.l ("Covidien"). The merger agreement provided for a two-step transaction, that is, a tender offer followed by a back-end short-form merger at the same price. To facilitate the short-form merger, Covidien was granted a top-up option that allowed it to purchase a number of ev3's shares that, when combined with the tendered shares, would enable Covidien to own more than 90 percent of ev3's outstanding shares. The option was subject to certain conditions. The purchase price for the option shares was the tender offer price and was to be paid with a promissory note with terms to be set in the future and determined by Covidien.[11]

The shareholder litigation challenging the transaction claimed that: the top-up option did not comply with Sections 152, 153 and 157 of the DGCL[12] which control the issuance of shares and options; the option was coercive because of "appraisal dilution"; and the board of directors had breached their fiduciary duties in granting the top-up option.[13]

The shareholder litigation settlement, described in a Memorandum of Understanding ("MoU"), provided that: the merger agreement was to be amended to specify the terms of the promissory note and the consideration to be received for the top-up shares; the ev3 board was to approve the amendments to the merger agreement at a meeting where the terms and operation of the top-up option were to be "thoroughly reviewed" and the necessary statutory determinations were to be made; the parties were to supplement the merger agreement to prevent any amendment of Section 1.4 of such agreement (with respect to the top-up option) in a manner that would adversely affect the rights of the remaining ev3 shareholders after the buyer became a majority shareholder; and, in an effort to resolve any concern about "appraisal dilution," the top-up shares and related consideration would not be considered for appraisal purposes.[14]

Threat of Appraisal Dilution

The plaintiff argued that the proportionate interest in the corporation of any non-tendering shareholders, who might exercise their appraisal rights, would be diluted by the issuance of millions of shares of ev3 common stock which would be outstanding at the time of the short-form merger.[15] Vice Chancellor Laster, however, expressed the view that the plain language of Section 262(h) of the DGCL calls for the exclusion of the top-up shares. Section 262(h) provides in part as follows:

> After the Court determines the stockholders entitled to an appraisal, the appraisal proceeding shall be conducted in accordance with the rules of the Court of Chan-

> cery, including any rules specifically governing appraisal proceedings. Through such proceeding the Court shall determine the fair value of the shares *exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation*, together with interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors.[16]

According to the Court, under this exception, debt incurred to finance a cash-out merger and business concessions that cannot take effect unless the merger is completed have been excluded from the determination of fair value as elements of value arising from the accomplishment or expectation of the merger.[17] As a result, Vice Chancellor Laster concluded that the same exclusion would apply to the issuance of top-up shares meant to facilitate a short-form merger and the receipt by the target corporation of cash or a promissory note in exchange for the issuance of such shares.[18]

The Court went on to explain that a key assumption in driving the "appraisal dilution" theory is a judicial finding of fair value ***in excess of*** the deal price:

> If, instead, the deal price exceeds fair value, then the issuance of top-up shares at the deal price increases the value of the corporation and, theoretically, appraisal value. In an arm's-length, synergistic transaction, the deal price generally will exceed fair value because target fiduciaries bargain for a premium that includes both a share of the anticipated synergies and a portion of the reduced agency costs that the acquirer will enjoy as a result of sole ownership.[19]

Additionally, Vice Chancellor Laster stated that ". . . the mechanics of the appraisal statute work against the possibility of coercion from 'appraisal dilution.'"[20] The Court also pointed out that a target corporation can expressly agree not to count top-up shares and the related consideration in any appraisal proceeding arising out of the merger.[21]

Statutory Shortcomings of the Olson Top-Up Option

The Court awarded the plaintiff the full amount of attorney's fees requested based primarily on the value provided by the plaintiff's attorney in remedying the statutory shortcomings of the *Olson* top-up option. As originally structured, the ev3 top-up option and any shares issued upon its exercise likely were void because of ev3's failure to follow the statutory provisions applicable to option issuance.[22] As a result, to the extent a short-form merger had closed in reliance on the resulting shares, the validity of the merger could have been attacked.[23]

Vice Chancellor Laster identified several material flaws in the merger agreement under the theory of statutory invalidity. First, Section 157(b) of the DGCL requires that the option terms, including the consideration to be provided for the shares underlying the option, be set forth in the certificate of incorporation "or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options, and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options."[24] The merger agreement set forth neither the consideration to be paid for the shares nor a formula by which such consideration could be determined. Although the merger agreement authorized the consideration to be paid by a promissory note, it failed to set forth the material terms of the note. The Court pointed out that because the merger agreement failed to set any terms for the promissory note, it could be readily inferred that there were no board resolutions approving such terms, which in fact was the case.[25]

Pursuant to the MoU, the ev3 board was required to meet to approve the amended merger agreement and to adopt an implementing resolution.[26] This requirement was meant to ensure that the

board of directors complied with the requirements of Sections 152, 153(a) and 157(d) of the DGCL[27] by determining the consideration to be received for the top-up option shares and adopted a resolution that provided for the creation and issuance of the top-up option as required by Section 157(b) of the DGCL.[28] Further, the MoU called for the amendment of the merger agreement to specify the material terms of the promissory note.[29] By requiring that the merger agreement include the terms of the promissory note, the parties complied with the requirements of Section 157(b) of the DGCL by confirming that the "instrument . . . evidencing" the top-up option set forth the consideration to be paid for the shares.[30]

Next, Section 157(d) of the DGCL requires that the consideration to be received for shares with par value "have a value not less than the par value thereof."[31] Section 153 of the DGCL contains a similar requirement.[32] According to the Court, because the terms of the promissory note were not agreed to at the time the ev3 board attempted to grant the top-up option, this determination could not be made by the board.[33] In addition, the Court pointed out that the board of directors of the target corporation is required by longstanding Delaware case law interpreting Section 152 of the DGCL and its statutory predecessors to determine the sufficiency of the consideration received for shares.[34] Under the original merger agreement, the directors did not make the determination as to the sufficiency of the consideration received for shares as required by Section 157(d) of the DGCL.[35]

Pursuant to the MoU, the merger agreement was amended to require that the buyer pay the par value of any top-up shares in cash. Prior to 2004, payment of the par value in cash was necessary to provide "constitutional consideration" for the shares.[36] Pursuant to Section 152, as amended, consideration may now consist of "cash, any tangible or intangible property or any benefit to the corporation, or any combination thereof."[37] Nevertheless, according to Vice Chancellor Laster, providing for payment of the par value in cash "eliminates any conceivable debate over whether the value of the consideration received for the top-up option shares might be less than the par value of those shares, as required by Section 153(a) [of the DGCL]."[38]

Lessons from Olson and Other Recent Delaware Decisions

As a result of lessons learned from *Olson* and other recent Delaware decisions, when structuring top-up options in the future, the following practical pointers should be considered:

- The merger agreement should expressly include language to avoid an appraisal dilution claim, that is it should provide that the top-up option, the top-up option shares and any promissory note issued in connection with the option exercise will be excluded from any appraisal calculation and process.
- The target's board of directors should adopt resolutions that specifically provide for the creation and issuance of the top-up shares, as required by Section 157(b) of the DGCL, and the determination of the sufficiency of the consideration to be received for the top-up shares as required by Sections 152, 153(a) and 157(b) and (d) of the DGCL.
- The option terms should be set forth in an instrument evidencing the top-up option, including the consideration to be paid for the top-up shares and a description of the material terms of any promissory note (e.g., payment schedule, interest, etc.), and such instrument should be specifically approved by the target's board and reflected in the board's resolutions.
- The *Olson* Court also suggests that cash be paid upon the exercise of the top-up option in an amount equal to the ag-

gregate par value of the stock to be issued, rather than a promissory note, to eliminate, in the Court's view, any doubt over whether the value of the consideration for the top-up shares might be less than the par value of those shares.[39] Query whether this course of action is required after the 2004 amendments to Section 152 of the DGCL.

Conclusion

Undoubtedly, the plaintiffs bar will develop new challenges to top-up options, and in the right case the Delaware Supreme Court may rule, but for the moment the Court of Chancery has provided useful guidance to deal lawyers on the use of top-up options in two-step acquisition transactions. As a result, as tender offers continue to gain in popularity, so too will the use of top-up options.

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[1] Approximately 23 percent of friendly public acquisition transactions in 2010 employed tender offers, versus 7.6 percent in 2006. *See* Steven M. Davidoff, *Behind the Growing Number of Tender Offers*, DealBook (N.Y. Times, New York, N.Y.), Oct. 14, 2010, *available at* http://dealbook.nytimes.com/2010/10/14/behind-the-growing-number-of-tender-offers/. Moreover, a substantial number of such friendly public deals utilized top-up options. The Delaware Court of Chancery in its memorandum opinion in *Olson v. ev3, Inc.*, C.A. No. 5583-VCL, at 3 (Del. Ch. Feb. 21, 2011), noted that top-up options had appeared in more than 93 percent of two-step deals during 2007, 100 percent of two-step deals during 2008 and more than 91 percent of two-step deals during 2009.

[2] *See* Transcript of Teleconference of the Court's Ruling, *In re ICX Technologies., Inc. Shareholder Litigation*, C.A. No. 5769-VCL (Del. Ch. Sept. 17, 2010) [hereinafter *In re ICX Technologies., Inc.*]; *In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487 (Del. Ch. 2010); and Transcript of Settlement Hearing, *In re Protection One, Inc. Shareholders Litigation*, C.A. No. 5468-VCS (Del. Ch. Oct. 6, 2010) [hereinafter *In re Protection One, Inc.*].

[3] C.A. No. 5583-VCL (Del. Ch. Feb. 21, 2011).

[4] DEL. CODE ANN. tit. 8, § 253 (2010).

[5] Tit. 8, § 251.

[6] *See* Transcript of Teleconference Plaintiff's Motion for Expedited Proceedings, *In re Gateway, Inc. Shareholders Litigation*, C.A. No. 3219-VCN (Del. Ch. Sep. 14, 2007); Transcript of Office Conference, *NECA-IBEW v. Prima Energy Corp.*, C.A. No. 522-N (Del. Ch. June 30, 2004).

[7] *See In re ICX Technologies., Inc.*, *supra* note 2, at 5-8; *In re Cogent, Inc.*, 7 A.3d at 504-08; and *In re Protection One, Inc.*, *supra* note 2, at 9-11.

[8] *In re Cogent, Inc.*, 7 A.3d at 505-09; *see also In re ICX Technologies., Inc.*, *supra* note 2, at 5.

[9] *In re Protection One, Inc.*, *supra* note 2, at 12, 16; s*ee* tit. 8, § 262.

[10] *See Olson v. ev3, Inc.*, C.A. No. 5583-VCL (Del. Ch. Feb. 21, 2011).

[11] *Id.* at 10.

[12] DEL. CODE ANN. tit. 8, §§ 152, 153, 157 (2010).

[13] *Olson*, C.A. No. 5583-VCL, at 11.

[14] *Id.* at 12-13.

[15] *Id.* at 16.

[16] *Id.* at 17 (quoting DEL. CODE ANN. tit. 8, § 262(h)) (emphasis added by the Court).

[17] *Id.* at 18 (citing *Cede & Co. v. JRC Acquisition Corp.*, No. Civ.A. 18648-NC, at *7, *7 n.71 (Del. Ch. Feb. 10, 2004) and *Allenson v. Midway Airlines Corp.*, 789 A.2d 572, 582 (Del. Ch. 2001)).

[18] *Id.* (citing *In re Protection One, Inc.*, *supra* note 2, at 16-18 ("I would never think . . . in [my] wildest dreams that you would hit an appraisal petitioner . . . you would reduce the value of any award to an appraisal petitioner because of a top-up option included in . . . the merger agreement that gave rise to the appraisal triggering event.")).

[19] *Olson*, C.A. No. 5583-VCL, at 18-19.

[20] *Id.* at 19.

[21] *Id.* at 20-21 (citing *In re ICX Technologies., Inc.*, *supra* note 2, at 5-8 (rejecting appraisal dilution claim as not meritorious when filed where transaction parties excluded top-up shares and related consideration for purposes of appraisal); *Gholl v. eMachines, Inc.*, No. Civ.A. 19444-NC, at 18 (Del. Ch. Nov. 24, 2004) (using parties' agreed-upon figure for number of shares in appraisal following two-step acquisition involving top-up option); *see also In re Sunbelt Beverage Corp. Shareholder Litigation*, C.A. No. 16089-CC, at 1 n.1 (Del. Ch. Jan. 5, 2010) (accepting parties' stipulation as to number of shares for purposes of appraisal)).

[22] *Olson*, C.A. No. 5583-VCL, at 21 (citing *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1137 (Del. 1991)).

[23] *Id.* at 21.

[24] *Id.* at 22 (quoting DEL. CODE ANN. tit. 8, § 157(b) (2010)).

[25] *Id.* at 23.

[26] *Id.* at 28.

[27] Tit. 8, §§ 152, 153(a), 157(d).

[28] *Olson*, C.A. No. 5583-VCL, at 28.

[29] *Id.* at 27.

[30] *Id.*

[31] *Id.* at 22 (quoting DEL. CODE ANN. tit. 8, § 157(d) (2010)).

[32] *See* tit. 8, § 153.

[33] *Olson*, C.A. No. 5583-VCL, at 24.

[34] *Id.* (citing *Field v. Carlisle Corp.*, 68 A.2d 817, 820 (Del. Ch. 1949)); *accord Bowen v. Imperial Theatres, Inc.*, 115 A. 918, 920 (Del. Ch. 1922)).

[35] *Id.* at 24-25.

[36] *Id.* at 28 (citing DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW & PRACTICE § 17.02, at 17-17 (1995) (describing the requirements of DEL. CONST. art. IX, §§ 3, 152 as they existed prior to the 2004 amendments)).

[37] *Id.* at 28 (quoting DEL. CODE ANN. tit. 8, § 152 (2010)).

[38] *Id.*

[39] *Olson*, C.A. No. 5583-VCL, at 28.