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Mergers & Acquisitions Update

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DE Court Enjoins Merger Over Disclosures Relating to Financial Advisor Fees and Management Employment Expectations

A recent Delaware decision enjoined a stockholders meeting to vote on a merger until the target company disclosed the amount and contingent nature of the fees payable to its financial advisor and the timing of the chief executive officer's expectation of post-closing employment with the buyer. Although the court found that the plaintiff was unlikely to succeed on the merits in challenging the board of directors' fiduciary duties in conducting the sale process, the decision shows the Delaware courts' continued scrutiny of disclosure of potential conflicts of interest.

Background

The decision, *In re Atheros Communications, Inc. Shareholder Litigation,* C.A. No. 6124-VCN (Del. Ch. Mar. 4, 2011), involved Qualcomm Incorporated's proposed $3.1 billion acquisition of Atheros Communications, Inc. Prior to entering into the merger agreement with Qualcomm, Atheros had retained a financial advisor and conducted a limited pre-signing market check by contacting two additional potential buyers. After only one of those potential buyers indicated any interest in the transaction but before any offer was made, Atheros entered into an exclusivity agreement with Qualcomm, leading to a definitive agreement providing shareholders with a 22% premium.

Sale Process was Reasonable

On a motion for a preliminary injunction, the court held that the plaintiff was unlikely to succeed in proving that the directors breached their so-called *Revlon* duties to obtain the best price reasonably available. It explained that, under *Revlon*, the court must "(1) make a determination as to whether the information relied upon in the decision-making process was adequate and (2) examine the reasonableness of the directors' decision viewed from the point in time during which the directors acted."

Applying that standard, the court held that the board acted reasonably and took an active role in the sale process, meeting numerous times and consulting with outside advisors. The court also stated that the board appeared to have made a "reasonable judgment" in contacting a short list of potential buyers after determining that some potentially interested parties were unlikely to have the financial wherewithal to consummate a transaction and others posed a competitive threat if they reviewed competitively sensitive information and Atheros remained independent. The court also noted that the board "was an independent board with deep knowledge of [Atheros's] industry and it employed a robust and sophisticated process."

Disclosure of Investment Banker Fees

The court then turned to the plaintiffs' disclosure claims. The plaintiff argued that Atheros's disclosure that its financial advisor would be "paid a customary fee, … a substantial portion of which will be paid upon completion of the Merger," did not provide stockholders with sufficient information. The court agreed, since 98% of the financial advisor's total compensation was contingent on consummation of the merger:

> Although the Proxy Statement reports that a "substantial portion" of the fee is contingent, the percentage of the fee that is contingent exceeds both common practice and common understanding of what constitutes "substantial." …. Stockholders should know that their financial advisor, upon whom they are being asked to rely, stands to reap a large reward only if the transaction

> closes and, as a practical matter, only if the financial advisor renders a fairness opinion in favor of the transaction.

Though it disclaimed any implication of wrongdoing by the financial advisor, the court was blunt in discussing the "extraordinary incentive" that may have been created by contingent compensation.

Disclosure of the CEO's Employment Discussions

The court also enjoined the merger vote pending supplemental disclosures regarding the CEO's post-closing employment discussions. The proxy statement provided that Atheros's CEO did not have "any discussions with Qualcomm regarding the terms of his potential employment with Qualcomm" until after a certain date. The preliminary record indicated, however, that the CEO had a strong expectation of employment earlier in the sale process, which the court deemed material to stockholders:

> Knowledge that, even though specific terms were not elicited until later in the process, [the CEO] was unaware that he would receive an offer of employment from Qualcomm at the same time he was negotiating, for example, the Transaction's offer price, would be important to a reasonable shareholder's decision regarding the Transaction.

Thus, the court held that, because the CEO had an "overwhelming reason to believe he would be employed" by Qualcomm after the merger, the date on which he first learned of such potential employment should be disclosed.

Conclusion

Atheros is one of several recent Delaware Court of Chancery cases addressing potential conflicts of financial advisors. In an April 2010 bench ruling in *In re Zenith National Insurance Corp. Shareholders Litigation*, for example, the court said it was a "close issue" on whether to require more disclosure of the sell-side bankers' prior engagements and overlapping deal teams with the buyer, though it ultimately determined such disclosure was not required. Then, in a December 2010 hearing, the court required a supplemental disclosure in *In re Art Technology Group, Inc.* to inform stockholders of the fees that the seller's financial advisor had received from the buyer on unrelated engagements. Atheros also comes less than three weeks after the Court of Chancery's much-discussed decision in *In re Del Monte Foods Company Shareholder Litigation*, where on a preliminary record it temporarily enjoined a stockholder vote due to alleged misconduct by the seller's financial advisor. In light of these cases, M&A parties can expect increased scrutiny from stockholder-plaintiffs into potential financial advisor conflicts.

The *Atheros* court's determination regarding the disclosure of the financial advisor's fees is also noteworthy, especially since the court acknowledged that most proxy statements disclose that an advisor is receiving "customary" fees without specifying the dollar amount of those fees. *Atheros* refused to create any bright-line rule addressing the "general debate" over whether the actual amount of a financial advisor's fees should always be disclosed. Instead, it held that, under the circumstances, such general disclosure was incomplete where 98% of the bankers' total fees were contingent.

M&A parties should also take note of the disclosure relating to the CEO's post-closing employment expectations with the buyer. Though the disclosure seems to have been accurate in that the CEO had not discussed any specific terms of employment, the court directed the company to disclose the time at which the CEO knew he was likely to be employed by the buyer. *Atheros* did not conclude, however, that the manner in which the sale process was conducted was unreasonable or that it was otherwise improper to let the CEO play a lead role in the negotiations. Where management may be retained by a buyer, target boards of directors are best advised to ensure that specific employment discussions are not held prematurely and that stockholders receive full disclosure about management's employment discussions.

If you have any questions about this decision or other corporate law matters, please contact Gary Thompson at (804) 788-8787 or gthompson@hunton.com, Roth Kehoe at (404) 888-4056 or rkehoe@hunton.com, Steven Haas at (804) 788-7217 or shaas@hunton.com or your Hunton & Williams LLP contact.

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