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Client Alert

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M&A Update: Royalty Payment to Buyer Was Not a "Deal Protection"

The Delaware Court of Chancery recently rejected a claim challenging a completed merger of a mining company. Among other things, the plaintiff claimed that a termination fee, when combined with a royalty payment granted to the buyer, amounted to impermissible "deal protections." The court found that a topping bidder could simply assume the royalty payment and, therefore, it was not a deal protection subject to enhanced judicial scrutiny. The decision is nevertheless a reminder of the contextual nature of deal protections and that unusual transaction terms could be scrutinized if they may have a chilling effect on topping bids.

Background

In re Paramount Gold & Silver Corp. S'holder Litigation, Consol. C.A. No. 10499-CB, mem. op. (Del. Ch. Apr. 13, 2017), involved a target company ("Paramount") with two primary assets: a mining project in Nevada and a mining project in Mexico. Paramount agreed to a bifurcated transaction with a third-party buyer. First, Paramount agreed to a merger in which Paramount stockholders would receive stock in the buyer. Second, Paramount would spin off the Nevada mining project to its stockholders prior to the completion of the merger. The merger agreement required Paramount to pay the buyer a termination fee of $5 million (3.42% of the merger value) if Paramount pursued an alternative transaction under certain circumstances. In addition, when the merger agreement was signed, Paramount granted the buyer a perpetual royalty stream in the Mexican mining project in exchange for $5.25 million. The royalty agreement was effective immediately and not contingent on the closing of the merger.

The Court's Opinion

The court began by observing that "deal protections" are "defensive devices against uninvited competing transactions" and thus subject to enhanced judicial scrutiny under the *Unocal* standard. It also observed that the termination fee was equal to 3.42% of the merger value and 2.72% of the combined value of the merger and the spin-off. The court noted that "this Court routinely has upheld termination fees of this magnitude."

The court then turned to the plaintiffs' attack on the royalty payment. It held that the royalty payment was not a "deal protection" because "plaintiffs have not pled any facts suggesting that a superior bidder had any obligation to buy out [the buyer's] royalty interest... in order to propose or consummate a transaction with Paramount." Rather, "a potential bidder could simply acquire Paramount subject to the Royalty Agreement, thereby assuming the obligations under the Royalty Agreement." In addition, the court held that the terms of the royalty agreement did not restrict Paramount from engaging in a merger with a third party. In other words, the royalty agreement did not give the buyer a "block right" to veto alternative transactions before the merger was completed. As such, the plaintiff had failed to state a claim, and the transaction, which had been approved by stockholders, was protected by the business judgment rule.

Conclusion

Typical “deal protections” include termination fees, matching rights, and no-solicitation restrictions. Delaware case law provides relatively clear guidance under which these ubiquitous devices will survive judicial scrutiny. Relevant factors include, among other things, the size of the premium payable to the target stockholders, the importance of the deal protections to the buyer, the parties’ negotiating leverage, and the extent to which the target has conducted a pre-signing market check or its directors otherwise had knowledge of the company’s alternatives.

Paramount Gold & Silver is a good reminder that unusual transaction terms could give rise to judicial scrutiny as deal protection devices. A royalty payment *could* be reviewed as a deal protection. Chancellor Bouchard hypothesized, for example, that if the royalty agreement had required a topping bidder to pay the initial buyer $5.25 million in addition to the $5 million termination fee, the combined payment of $10.25 million (or 7.02% of the total transaction value) “would be problematic.” But this was not the case. First, the royalty agreement did not prohibit other transactions, an issue which would have raised concerns for its potential to preclude topping bids and limit the board’s discretion. Second, if Paramount pursued another deal, the royalty agreement did not trigger any payment to the initial buyer – let alone a payment that would be preclusive to a topping bidder or coercive to Paramount’s stockholders. Nor did the royalty agreement involve a lock-up of any key assets (e.g., “crown jewels”). Rather, the royalty payment was less than 1% of the net returns from the mining project’s returns.

Lastly, from a doctrinal standpoint, the court declined to address whether a fully informed vote of disinterested stockholders would cleanse deal protections otherwise reviewable under *Unocal*. Under a growing body of case law stemming from the Delaware Supreme Court's decision in *Corwin*, such a vote results in protection of the business judgment rule. The *Paramount* court noted some "apparent tension" between *Corwin* and prior case law with respect to its review of unreasonable deal protection terms. The court concluded, however, that it need not address the issue because the royalty agreement was not a deal protection and the plaintiffs had conceded the termination fee was not unreasonable.

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