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In Defense of Defensive Devices: How Delaware Discouraged Preventive Measures in *Omnicare v. NCS Healthcare*

*Andrew D. Arons**

I. INTRODUCTION

Imagine a company facing bankruptcy and foreseeing no hope of maintaining the current state of its business. As a final effort to save some vestiges of the company, it seeks out another company with which to merge in order to maintain the business in conjunction with another company. Two possibilities arise out of a year-and-a-half long search. First, one company offers a merger, but only by means of an asset sale through bankruptcy court at a price substantially lower than the face value of the company's debt. Second, the other company fortunately offers terms that preserves the corporation, provide relief to creditors, and satisfy the shareholders, albeit with a condition. This second company will only accept terms providing the only basis for preserving the legitimate goals of the target company and satisfying the target's members if the target company agrees to several provisions which will prevent any other company from usurping the acquiring company's place. Now imagine that the Delaware Supreme Court has eliminated hope for this second, more beneficial option. Unfortunately, imagination has become reality due to a recent split decision in *Omnicare, Inc. v. NCS Healthcare Inc.*¹

This note discusses the Delaware Supreme Court's recent split decision to invalidate a merger agreement due to deal protection devices agreed to by NCS Healthcare (NCS) and Genesis Health Ventures, Inc (Genesis).² Part II of this note discusses merger agreements, the factual background of *Omnicare*, and the majority's arguments. Part III discusses how the majority came to an incorrect holding. Finally, part IV suggests possible effects the majority's decision will have on future merger transactions.

* DePaul University College of Law, J.D., expected May 2005; University of Illinois-Urbana/Champaign, B.A., 2002.

1. 818 A.2d 914 (Del. 2003) (3-2 decision).

2. *Id.* at 918 ("We have concluded that, in the absence of an effective fiduciary out clause, those defensive measures are both preclusive and coercive").

II. BACKGROUND

a. *Mergers in General*

A merger is a transaction which may occur under state corporation law where at least two corporations combine, causing only one corporation to maintain its identity, while the other ceases to exist in separate form.³ Mergers are creatures of state corporate law, and therefore the rules governing a particular merger may vary somewhat between jurisdictions depending on the individual corporate statutes and local judicial interpretation. A merger is distinguishable from an acquisition, in that an acquisition may not always be at the assent of both corporations, while a merger is often characterized by a mutual interest in combining the corporate entities.⁴ In a merger, the remaining corporation is called the acquirer, and the corporation that loses its identity is called the target corporation. There are numerous reasons why a target corporation would seek its own sale, including business development, need for financing, liquidation of assets, and as a means to block a takeover bid.⁵

Mergers usually involve several steps. First, the acquiring and target corporate managements reach a preliminary agreement and issue a press release according to securities laws to prevent unfair advantage to insiders based on their knowledge.⁶ The boards then adopt a merger agreement and notify their shareholders accordingly.⁷ Sometimes the boards may incorporate protective devices into the merger agreement to mitigate the risks due to unanticipated events. For instance, 'lockups' add contractual provisions to prevent the deal from falling through by prohibiting the seller from entertaining bids from other prospective purchasers.⁸ Depending on the circumstances and the jurisdiction of the corporations, a majority of shareholders must then accept the merger agreement. Consideration for the merger provided to the target corporation may come in the form of securities in the acquiring corporation, debt, cash, or some combination thereof.⁹ Generally, dissenting shareholders have an appraisal remedy in which they have the right to demand that the corporation purchase their shares for fair price, which may be based on the market price or a

3. Mathew Bender, *Corporate Acquisitions and Mergers* §1.01(1) (LexisNexis 2003).

4. *Id.*

5. *Id.* at §1.01(4).

6. *Id.* at §2.02(1).

7. Bender, *supra* note 3, at §2.02(1).

8. *Id.*

9. *Id.*

judicial appraisal of the value of the shares.¹⁰ To complete the merger, the surviving corporation files articles of merger with the state of incorporation and succeeds to the target's assets and liabilities based on the merger agreement.¹¹

b. *The Circumstances of the Merger in OMNICARE v. NCS*

i. NCS' Search for an Acquirer

In 1999, NCS, a leading provider of pharmacy services to long-term care institutions, experienced difficulties in collecting accounts receivables due in part to adverse market conditions in the health care industry.¹² These financial troubles led to NCS's stock price dropping from twenty dollars per share to five dollars per share within one year.¹³ Soon after, in 2001, NCS defaulted on roughly \$350 million in debt dropping its price per share of Class A common stock to under fifty cents a share.¹⁴ Prior to the default, NCS retained UBS Warburg, L.L.C. in February 2000 to find investors or acquirers.¹⁵ After receiving only one unsatisfactory offer, NCS switched its financial advising from UBS Warburg, L.L.C. to Brown, Gibbons, Long & Company in December 2000.¹⁶ In 2001, when NCS's financial condition deteriorated and the company received formal notice of default and acceleration from the Noteholders' trustee, the Noteholders formed an 'Ad Hoc Committee' to represent their financial interests.¹⁷ NCS discussed several offers to restructure the company through bankruptcy, but found that the offers did not provide sufficient consideration for its shareholders.¹⁸

10. *Id.*

11. *Id.*

12. *Omicare*, 818 A.2d at 918, 920. (In 1999, the market conditions in the healthcare industry were adversely affected when the government and third-party providers changed the timing and level of reimbursements. *Id.* at 920. See Nathalie D. Martin & Elizabeth Rourke, *Les Jeux Ne Sont Pas Faits: The Right to Dignified Long-Term Care in the Face of Industry-Wide Financial Failure*, 10 CORNELL J.L. & PUB. POL'Y 129 (2000), for more information regarding the changes in the healthcare industry due to the Prospective Payment System mandated in the Balanced Budget Act of 1997 and amended by the Balanced Budget Refinement Act of 1999.

13. *Omicare*, 818 A.2d at 920.

14. *Id.* (stating that NCS common stock traded in a range of nine cents to fifty cents per share until days before the announcement of the transaction at issue).

15. *Id.* at 921.

16. *Id.* at 920-921. (The Noteholders held approximately \$350 million of NCS debt instruments which included senior bank debt of \$206 million and convertible subordinated debentures of \$102 million.)

17. *Id.* at 921.

18. *Omicare*, 818 A.2d at 921.

Finally, in 2001, NCS contacted Omnicare, another Delaware company in the institutional pharmacy business,¹⁹ to discuss a possible transaction, to which Omnicare sent a proposal to acquire NCS in a bankruptcy sale under §363 of the Bankruptcy Code for \$225 million subject to completion of due diligence.²⁰ Omnicare raised its bid to \$270 million in August, which still left NCS with \$80 million of outstanding debt, and thus would not provide full recovery to the Noteholders, and would provide no recovery to NCS's shareholders.²¹ Meanwhile, Omnicare targeted NCS's customers in attempts to entice them to switch suppliers.²² Despite October negotiations, Omnicare held fast to its requirement that the merger only occur through an asset sale. Secretly, the Ad Hoc Committee of Noteholders negotiated with Omnicare and announced an offer in February 2002 for another asset sale in bankruptcy for more than \$313 million.²³

One month earlier, in January 2002, the Ad Hoc Committee contacted Genesis, a "leading provider of healthcare and support services to the elderly"²⁴ which recently emerged from a bankruptcy of its own.²⁵ Simultaneously, NCS began to improve, prompting the directors to believe that its Noteholders and shareholders could benefit from a more advantageous merger deal than those currently on the table. To seek out such a deal and ensure the proper fiduciary duties were provided to the corporation as a whole, NCS formed the Independent Committee made up of neither NCS employees nor major shareholders in March 2002.²⁶ While the board granted the Independent Committee the power to negotiate possible merger transactions,

19. *Id.* at 918.

20. *Id.* at 921 (Section 363 of the Bankruptcy Code permits a trustee or debtor in bankruptcy to sell or lease assets of the entity upon sufficient notice to creditors and the bankruptcy court. 11 USC 363(b), (c). Obviously, sales through bankruptcy also require consideration of the bankruptcy laws that are not directly at issue in this note).

21. *Id.*

22. Omnicare, 818 A.2d at 921 n.3. (These actions to entice NCS's customers away occurred several times and were revealed during discovery.)

23. *Id.* at 921. (stating that the offer was for \$313,740,000).

24. *Id.* at 919.

25. *Id.* at 921.

26. *Id.* at 922. (In contrast to the Independent Committee, the NCS board of directors consisted of four members, two of which, Jon H. Outcalt and Kevin B. Shaw, at the time of the dispute collectively owned 230,988 shares of Class A stock and 4,617,220 shares of Class B stock constituting more than sixty-five percent of the voting power of NCS stock. *Id.* at 918-920. Additionally, Outcalt and Shaw's holdings encompassed substantially all of the outstanding shares of the Class B stock. Omnicare, Inc. v. NCS Healthcare, Inc, 825 A.2d 264, 266 (Del. Ch. 2002), *rev'd*, 818 A.2d 914 (Del. 2003).)

the full NCS board retained approval powers and shared its legal and financial counsel with the Independent Committee.²⁷

ii. Genesis and NCS Proposed Merger Terms

Based in part on its previous loss of a bidding war to Omnicare, Genesis did not want to simply negotiate as a stalking horse, which would “only result in [their] valuation. . . being publicly disclosed, and thereby creating an environment where Omnicare felt to maintain its competitive monopolistic positions, that they had to match and exceed that level.”²⁸ Genesis negotiated a transaction outside of bankruptcy with favorable terms for NCS. In June, Genesis proposed a “repayment of the NCS senior debt in full, full assumption of trade credit obligations, an exchange offer or direct purchase of the NCS Notes providing NCS Noteholders with a combination of cash and Genesis common stock. . . , and \$20 million in value for the NCS common stock.”²⁹ Several days later Genesis agreed to increase its offer and suggested \$24 million in consideration for the NCS common stock in the form of Genesis common stock.³⁰ Most importantly for the litigation leading to this case, the proposed transactions also included several clauses intended to provide Genesis with a degree of certainty that the parties would consummate their negotiated transaction.³¹

Genesis absolutely refused to continue to work towards closing the agreement unless NCS agreed to act on an exclusive basis with Genesis.³² NCS’s legal counsel first examined Genesis’s proposed exclusivity agreement, and the Independent Committee met shortly afterwards in July to consider it as well.³³ During the Independent Committee meeting, a summary of Genesis’ new and improved terms were presented which would repay the NCS senior debt in full, pay the notes’ par value with a combination of cash and Genesis stock, pay the NCS shareholders \$24 million of Genesis stock, and would assume the additional liabilities to trade and other unsecured creditors.³⁴ The Independent Committee was told that Genesis required the Exclusiv-

27. Omnicare, 818 A.2d at 922.

28. *Id.* at 922 (quoting a Genesis advisor’s testimony stating that Genesis wanted a degree of certainty that if it was willing to pursue a negotiated merger agreement, Genesis would be able to consummate that transaction).

29. *Id.*

30. *Id.* at 923.

31. *Id.*

32. Omnicare, 818 A.2d at 923.

33. *Id.*

34. *Id.* (The assumption of liabilities is available due to the structure of the transaction as a merger, versus an asset sale through bankruptcy).

ity Agreement in order to help secure a completely locked up transaction preventing NCS from accepting a higher Omnicare bid.³⁵ The Committee was also told that Genesis had previously suffered in other acquisition negotiations due to Omnicare outbidding them at the last minute, and therefore wanted a “bulletproof deal or they were not going to go forward.”³⁶ Thereafter, NCS executed the exclusivity agreement and Genesis provided draft agreements for the merger, Noteholders’ support agreement, and voting agreements for two NCS shareholders who held a majority of the voting power of NCS common stock.³⁷ These Voting Agreements, entered into between Genesis and the two majority shareholders, Outcalt and Shaw, would become a main point of contention in the *Omnicare* litigation.³⁸ During the negotiations that followed over the next several weeks the Independent Committee and Ad Hoc Committee again successfully encouraged better terms from Genesis.³⁹

Omnicare then renewed its interest in NCS and based on the increasing price of NCS stock, surmised that NCS was negotiating a deal that most likely included payment for its stock, and for the first time submitted a proposal that did not involve a sale of assets in bankruptcy.⁴⁰ The offer suggested retiring NCS’s senior and subordinated debt at par value plus accrued interest, in addition to providing the shareholders three dollars in cash for their shares. Furthermore, the offer was conditioned upon negotiating a merger agreement, ob-

35. *Id.*

36. *Id.*

37. *Omnicare*, 818 A.2d at 923.

38. (The voting agreements stated:

The Stockholder hereby irrevocably and unconditionally agrees to vote or to cause to be voted all of the Shares then owned of record or beneficially by him at the Company Stockholders Meeting and at any other annual or special meeting of shareholders of the Company where any such proposal is submitted, and in connection with any written consent of stockholders, (A) in favor of the [Merger] and (B) against (i) approval of any proposal made in opposition to or in competition with the [Merger] and the transactions contemplated by the Merger Agreement, (ii) any merger, consolidation, sale of assets, business combination, share exchange, reorganization or recapitalization of the Company or any of its subsidiaries, with or involving any party other than as contemplated by the Merger Agreement, (iii) any liquidation or winding up of the Company, (iv) any extraordinary dividend by the company, (v) any change in the capital structure of the Company (other than pursuant to the Merger Agreement) and (vi) any other action that may reasonably be expected to impede, interfere with, delay, postpone or attempt to discourage the consummation of the transactions contemplated by the Merger Agreement.)

Omnicare, 825 A.2d at 264, 268 (Del. Ch. 2002), *rev'd*, 818 A.2d 914 (Del. 2003).

39. *Omnicare*, 818 A.2d at 923.

40. *Id.* at 924.

taining third party consents, and completing due diligence.⁴¹ A member of the Ad Hoc Committee responded to these attractive economic terms and unsuccessfully tried to convince Omnicare to drop the due diligence condition.⁴² NCS was unable to respond to the offer due to the Genesis exclusivity agreement that “precluded NCS from ‘engaging or participating in any discussions or negotiations with respect to a Competing Transaction or a proposal for one.’”⁴³ Nevertheless, the Independent Committee met to discuss a response and determined that further negotiations with Omnicare would present “an unacceptable risk that Genesis would abandon merger discussions.”⁴⁴ The Committee based this decision on Omnicare’s past proposals through bankruptcy and refusal to consider a merger.⁴⁵ The Committee also relied on the fact that Omnicare only negotiated with the Noteholders’ representatives in the Ad Hoc Committee instead of the NCS representatives. Therefore, the Committee felt that the risk of losing the Genesis proposal was too substantial.⁴⁶

After Genesis improved its terms in response to the Omnicare offer, the Independent Committee and NCS board of directors approved the merger agreement. The new terms would retire the Notes by the terms of the indenture, including, for the first time, payment of all accrued interest and a redemption premium; an eighty percent increase in the exchange ratio for NCS common stock to a one to ten ratio; and a four million dollar decrease in the termination fee to six million dollars.⁴⁷ However, these terms were only valid if NCS approved the transaction by midnight of the following day, otherwise Genesis would end discussions and withdraw its offer.⁴⁸ In addition, the merger agreement allowed NCS stockholders to exercise their appraisal rights, required NCS to submit the merger agreement to NCS shareholders even if the board changed its recommendation for the merger, and prevented NCS from discussing alternative acquisition of NCS with third parties unless the alternative offer was an unsolicited written proposal with specific terms the board believed to be superior, and the third party would execute a confidentiality agreement compa-

41. *Id.*

42. *Id.*

43. *Id.*

44. Omnicare, 818 A.2d at 924.

45. *Id.* (noting that Omnicare would be considered a “competing transaction”).

46. *Id.*

47. *Id.* at 924-925.

48. *Id.* at 925.

rable to Genesis.⁴⁹ Moreover, two shareholders, Outcalt and Shaw, who held the majority of the voting power of NCS stock, were required to enter into voting agreements with Genesis in which the two shareholders voting in their shareholder capacity would irrevocably vote all of their shares in favor of the agreement.⁵⁰

iii. The Basis of NCS' Approval of Genesis' Required Merger Terms

While determining whether to approve the merger agreement, the Independent Committee met first and based on full information of all material facts and the Committee's feeling that Genesis was serious about the deadline, voted unanimously in recommending the merger to the board.⁵¹ The board then convened and concluded that the risk of the possible loss of the Genesis deal in conjunction with the uncertainty of Omnicare's latest offer weighed in Genesis' favor, and the board approved the Genesis transaction.⁵² At this point, the board authorized the majority shareholder voting agreements which locked up those shareholders' votes in favor of the merger. The board was informed by its legal counsel at this time that the voting agreements guaranteed shareholder approval of the merger even if the board changed or withdrew its recommendation, thus, "*preventing NCS from engaging in any alternative or superior transaction in the future.*"⁵³ Within hours of the execution of the merger agreement, Omnicare faxed a proposal to NCS with a draft merger agreement attached and later announced a tender offer for NCS's shares at \$3.50 a share.⁵⁴ The Independent Committee, the full board of directors, and their legal and financial advisers all found that Omnicare's interest would not lead to a 'superior proposal' as defined by the Genesis Merger agree-

49. *Id.* at 925-926 (Two of these requirements were somewhat redundant under Delaware corporate law, which governed this transaction, since they are required in all mergers. Appraisal rights, which provide shareholders with a fair value for their shares determined by the market or the court, are always available to minority shareholders who do not wish to participate in the merger. 8 Del. C. §262. Additionally, § 281 of the Delaware corporate statute requires submission of merger agreements to the shareholders for a vote regardless of the board's recommendation one way or another. 8 Del. C. §281. Statutory sections such as these are common in corporate statutes with regards to a merger, since a merger, or termination of the corporate entity, is one of the most significant actions that can occur within a corporation).

50. Omnicare, 818 A.2d at 926. (Outcalt and Shaw held more than 65% of the voting power of NCS stock. It is important to note the voting agreement specifically stated that these two shareholders, who also held the positions of Chairman of the Board, President, CEO, and director were acting in their capacity as shareholders.)

51. *Id.* at 925.

52. *Id.*

53. *Id.* (emphasis in original).

54. *Id.* at 926.

ment exclusivity provision governing discussions of alternative offers, but NCS did receive a waiver from Genesis allowing them to discuss Omnicare's offer with Omnicare.⁵⁵ Omnicare irrevocably committed itself to a transaction and agreed to acquire all outstanding NCS shares at its tender offer price causing the NCS board to withdraw its recommendation that the shareholders vote for the Genesis merger; NCS's financial advisor also withdrew its fairness opinion of the Genesis merger.⁵⁶ Even while the board withdrew its recommendation, it admitted in a SEC filing that it recognized the Genesis merger agreement prevented NCS from accepting the merger proposal and the voting agreements guaranteed NCS shareholder approval of the Genesis merger.⁵⁷ NCS shareholders and Omnicare then commenced the litigation at issue in *Omnicare v. NCS*⁵⁸ to prevent the completion of the Genesis transaction.⁵⁹

The case as decided by the Delaware Supreme Court is actually a consolidated appeal from two separate actions. Omnicare sought to invalidate the merger agreement on fiduciary duty grounds and challenged the majority shareholder voting agreements.⁶⁰ Several NCS shareholders also brought an action to invalidate the merger, alleging the directors breached their fiduciary duty in creating a process that would not produce the highest value for the shareholders.⁶¹ In the lower court Omnicare action, the Court of Chancery dismissed Omnicare's fiduciary duty claims for lack of standing, and held that although Omnicare had standing as a bona fide bidder to convert the two majority shareholders' Class B stock to Class A stock, NCS's charter did not in fact require an automatic conversion under these facts, and dismissed Omnicare's action accordingly.⁶² The Court of Chancery also denied a preliminary injunction of the merger sought

55. *Omnicare*, 818 A.2d at 927.

56. *Id.*

57. *Id.*

58. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 825 A.2d 264 (Del. Ch. 2002).

59. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 927 (Del. 2003).

60. *Id.* at 919. (This action was C.A. No. 19800 in the Court of Chancery). *Id.*

61. *Id.* (This action was C.A. No. 19786 in the Court of Chancery). *Id.*

62. *Id.* at 919-920 (Section 7(d) of NCS's Charter stated:

Any purported transfer of shares of Class B Common Stock other than to a Permitted Transferee shall automatically, without any further act or deed on the part of the Corporation or any other person, result in the conversion of such shares into shares of Class A Common Stock on a share-for-share basis, effective on the date of such purported transfer.

Omnicare, 825 A.2d at 267-268 (Del. Ch. 2002). An automatic conversion of the two shareholders' shares from Class A to Class B would decrease these shareholders' votes per share by a factor of ten, a difference of about forty-one million votes, since they had a combined total of more than 4.6 million shares of Class B stock. *Omnicare*, 818 A.2d at 919-920 (Del. 2003).)

by the NCS shareholders.⁶³ The Delaware Supreme Court reversed in a split decision, specifically reversing the denial of the preliminary injunction and breach of fiduciary duty claims.⁶⁴ The Chief Justice and Justice Steele also wrote two dissenting opinions, which criticized the majority's holding and analysis.⁶⁵

c. *The Decision in Omnicare v. NCS*

i. Two Primary Cases in the Majority's Analysis

In upholding the causes of action against Omnicare, the majority relied heavily upon Delaware's requirements for enhanced judicial scrutiny of board transactions as described in *Unocal Corp. v. Mesa Petroleum Co.*⁶⁶ and *Unitrin, Inc. v. American General Corp.*⁶⁷ In *Unocal*, the Delaware Supreme Court upheld a stock repurchase plan intended as a defensive device against a tender offer.⁶⁸ Mesa Petroleum Company owned about 13% of Unocal's stock and began a two-tier cash tender offer for about 37% of Unocal's outstanding stock.⁶⁹ In response, Unocal's board, which included a majority of eight outside directors, rejected Mesa's tender offer as inadequate.⁷⁰ The board decided that if Mesa acquired a set amount of Unocal stock, Unocal would buy the remaining 49% of outstanding stock.⁷¹

The *Unocal* court focused much of its attention on whether the business judgment rule was applicable to the management repurchase plan in response to the two-tiered cash tender offer.⁷² The court first noted that an enhanced duty calling for judicial examination may arise before the protections of business judgment rule are applied due to "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its sharehold-

63. *Id.* at 920.

64. *Omnicare*, 818 A.2d at 939.

65. *Id.* at 939, 946.

66. 493 A.2d 946 (Del. 1985).

67. 651 A.2d 1361 (Del. 1995).

68. *Unocal*, 493 A.2d at 958.

69. *Id.* at 949.

70. *Id.* at 950-951

71. *Id.*

72. *Id.* at 953. (The business judgment rule presumes that directors of a corporation acted on an informed basis, in good faith and in the honest belief that when they made a business decision, the action was in the best interests of the company. *Id.* at 954 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Where the business judgment rule applies, "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Id.* (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717,720 (Del. 1971). Thus, a court adopts a deferential approach to business decisions governed by the business judgment rule.)

ers.”⁷³ When a director conflict of interest arises, “directors must show they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person’s stock ownership” and can satisfy that burden “by showing good faith and reasonable investigation.”⁷⁴ Satisfaction of this burden is “materially enhanced by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards.”⁷⁵

The court held that directors have a fiduciary duty to act in the best interests of the corporation’s shareholders and this duty extends to protect the corporation and its owners from perceived harm, but the corporation may not use “any Draconian means available.”⁷⁶ This standard of proof is designed to ensure that a defensive measure to impede a takeover is motivated by a good faith concern for the corporation and its shareholders’ welfare.⁷⁷ Moreover, for defensive measures to be evaluated under the business judgment rule, they must be reasonable in relation to the threat posed.⁷⁸ In order to be reasonable in relation to the threat posed, the directors must analyze the nature of the takeover bid and the effect on the corporation.⁷⁹ For instance, the board may consider the “inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.”⁸⁰ The Unocal court agreed with the Court of Chancery that the directors exercised their good faith belief in opposing Mesa’s tender offer based on their belief that it was inadequate and coercive.⁸¹ Therefore, Unocal’s plan was found “reasonable in relation to the threat the board rationally and reasonably believed was posed by Mesa’s inadequate and coercive. . . tender offer,” entitling measurement of the board’s action by the business judgment rule.⁸²

73. *Unocal*, 493 A.2d at 954.

74. *Id.* at 955 (citing and quoting *Cheff v. Mathes*, 199 A.2d 554-555 (Del. 1964).)

75. *Id.* (citing *Aronson*, 473 A.2d at 812, 815.)

76. *Id.* (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).)

77. *Id.* (citing *Cheff*, 199 A.2d at 554-555).

78. *Unocal*, 493 A.2d at 955.

79. *Id.*

80. *Id.* (Citing Lipton and Brownstein, *Takeover Responses and Directors’ Responsibilities: An Update*, p. 7, ABA National Institute on the Dynamics of Corporate Control (December 8, 1983).)

81. *Id.* at 958.

82. *Id.*

Ten years after *Unocal*, the Delaware Supreme Court reexamined situations in which enhanced judicial scrutiny should apply before employing the business judgment rule with regard to defensive actions in *Unitrin v. American General*.⁸³ In *Unitrin*, the court considered Unitrin's stock repurchase plan in response to American General's public proposal to acquire Unitrin's stock, and held that the Court of Chancery misapplied the proportionality requirement as set forth in *Unocal*.⁸⁴ The *Unitrin* court lays out the proper enhanced scrutiny procedure as first determining whether the target company board's defensive actions were draconian by being either preclusive or coercive, and then if the measures were not draconian, determining whether the actions were within a range of reasonable responses to the threat posed by the acquiring corporation.⁸⁵ The *Unitrin* court indicated that three levels of judicial review can apply to a shareholder's challenge of the directors' actions, "the traditional business judgment rule, the *Unocal* standard of enhanced judicial scrutiny, or the entire fairness standard."⁸⁶ Even before *Unocal's* enhanced judicial scrutiny applies, a court must first determine whether the conduct at issue was defensive.⁸⁷

In *Unitrin*, the court agreed with the lower court's finding that the board's actions were in response to a perceived threat.⁸⁸ The court then noted, "Unocal's standard of enhanced judicial scrutiny is proper whenever the record reflects that a board of directors took defensive measures in response to a 'perceived threat to corporate policy and effectiveness which touches upon issues of control.'"⁸⁹ To reap the deference of the business judgment rule, a board has the burden of satisfying a reasonableness test by demonstrating it had reasonable grounds to believe a danger to corporate policy and effectiveness existed, and then demonstrate that it satisfies a proportionality test by demonstrating the board's defensive response was reasonable in rela-

83. *Unitrin*, 651 A.2d at 1391.

84. *Id.* at 1366, 1367.

85. *Id.* at 1367.

86. *Id.* at 1371. (These three standards are on a spectrum of judicial scrutiny with the business judgment rule the most deferential, the entire fairness standard subject to the most scrutiny, and the *Unocal* standard somewhere in between. The entire fairness standard applies if the business judgment rule is defeated and requires judicial scrutiny of both fair dealing and fair price. *Id.* at n7 (quoting *Grobow v. Perot*, 539 A.2d 180,187 (Del. 1988), *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989), 8 Del.C §144(a)(3).)

87. *Id.* at 1372.

88. *Unitrin*, 651 A.2d at 1372. (The court also did not dispute the lower court's finding that had the "board enacted the repurchase program independent of a takeover proposal, its decision would be reviewed under the traditional business judgment rule.") *Id.*

89. *Id.* at n9 (quoting *Stroud v. Grace*, 606 A.2d 75, 82 (Del. 1992).)

tion to the threat posed.⁹⁰ Additionally, if the board does not satisfy *Unocal*, their actions are not automatically invalidated; instead, the board must then satisfy the entire fairness standard.⁹¹

Turning its attention to the proportionality test, the court indicated that “the threat associated with a particular hostile offer sets the parameters for the range of permissible defensive tactics,” and the board must have acted in reasonable relation to the threat posed to shareholder interests.⁹² The reasonableness of defensive measures depends on a “clear identification of the nature of the threat.”⁹³ An evaluation of the board’s overall response as well as the justification for each of the defensive measures and the results they achieve is also important under the proportionality test, because the board may not use any draconian means available nor act “solely or primarily out of a desire to perpetuate themselves in office.”⁹⁴ A finding of proportionality is directly correlated to whether defensive measures were draconian because they were either coercive or preclusive in nature.⁹⁵ For example, coercive circumstances may arise when the board’s defensive measures are “aimed at ‘cramming down’ on its shareholders,” and preclusive circumstances may arise if the measures take away the shareholders right to receive tender offers and fundamentally restrict proxy contests.⁹⁶ If the defensive measures are not found to be draconian, the proportionality test then focuses on whether the actions were within the range of reasonableness.⁹⁷ If the defensive measures are not draconian and the actions are within the range of reasonableness, a court “must not substitute its judgment for the board’s.”⁹⁸ Finally, if the board satisfies *Unocal*’s enhanced judicial scrutiny such that the business judgment rule does apply, the plaintiffs must demonstrate “by a preponderance of the evidence that the directors’ decisions were *primarily* based on (1) perpetuating themselves in office or (2) some

90. *Id.* at 1373, (citing *Unocal* 493 A.2d at 955. Traditionally a board’s response to a merger offer is tested by the business judgment rule “since a statutory prerequisite (8 Del.C. §251(b)) to a merger transaction is approval by the Board before a stockholder action.” *Id.* at 1375-1376 (quoting and citing *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1142, 1154 (Del. 1990).))

91. *Id.* at n18 (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).)

92. *Id.* at 1384 (quoting *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1288 (Del. 1989).)

93. *Unitrin*, 651 A.2d at 1384 (quoting *Paramount Communications*, 571 A.2d at 1154.)

94. *Id.* at 1387 (quoting *Unocal*, 493 A.2d at 955.)

95. *Id.*

96. *Id.* (citing *Paramount Communications*, 571 A.2d at 1154-1155; *Moran v. Household In’l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985).)

97. *Id.* at 1387-88. (citing *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994).)

98. *Unitrin*, 651 A.2d at 1388.

other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or (3) being uninformed.”⁹⁹

ii. The Majority’s Argument in *Omnicare*

The *Omnicare* court first investigated which circumstances and methods are subject to *Unocal*’s enhanced judicial scrutiny to determine whether the NCS board’s approval of the defensive devices could withstand the challenges from *Omnicare* and the NCS shareholders. First, the court attempted to deemphasize that *Unocal*’s holding was based on *hostile* takeover proposals by citing *Moran v. Household* for the proposition that *Unocal* applies “to the adoption of a stockholder’s rights plan, even in the absence of an immediate threat.”¹⁰⁰ The court also looked at the ‘Revlon duties,’ which require enhanced judicial scrutiny when a merger causes a change in corporate control, but determined that *Revlon* did not apply.¹⁰¹ Furthermore, “the adoption of structural safety devices alone does not trigger *Revlon*. Rather. . . *such devices are properly subject to a Unocal analysis*.”¹⁰² The court stated that in order to determine whether defensive devices are approved pursuant to the board’s fiduciary duty, the court must first examine (1) any conflicts arising out of the board’s interest in protecting its own merger transaction, (2) the shareholders’ statutory right to decide whether or not to approve a merger, and (3) a board’s continuing responsibility to exercise its fiduciary duties after it has executed the merger agreement.¹⁰³ This conflict arises also because “[d]efensive devices taken to protect a merger agreement executed by a board of directors are intended to give that agreement an advantage over any subsequent transactions that materialize before the merger is approved by the stockholders and consummated.”¹⁰⁴ When a merger does not involve a change of control, but the defensive devices in the executed merger agreement are challenged based

99. *Id.* at 1390. (emphasis in original, quoting *Unocal*, 493 A.2d at 958.)

100. *Omnicare v. NCS*, 818 A.2d at 928 (citing *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985).) (This is important because most other cases only applied the enhanced scrutiny, utilized by the *Omnicare* Majority, to defensive measures in response to *hostile* takeovers, as opposed to measures incorporated into friendly mergers such as in *Omnicare*. See, e.g., *Unocal*, 493 A.2d at 949; *Unitrin*, 651 A.2d at 1368-1369; *Mills Acquisition Co. v. Macmillan, Inc.* 559A.2d 1261, 1265 (Del. 1988)).

101. *Id.* at 928-930 (citing *Paramount v. QVC*, 637 A.2d at 47; *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173, 182 (Del. 1986). The Court states that the Court of Chancery’s decision to use the business judgment rule instead of *Revlon* is “not outcome determinative for the purposes of deciding this appeal.” *Id.*)

102. *Id.* at 930 (quoting *Paramount v. Time*, 571 A.2d at 1151. (emphasis in original).)

103. *Id.*

104. *Id.* at 932.

on their effect on a subsequent competing merger, the *Unocal* scrutiny arises.¹⁰⁵

After walking through the applicable tests Delaware courts have applied for enhanced scrutiny, the court then attempted to apply *Unocal* and its progeny to the *Omnicare* facts. The court found that the stockholder voting agreements were “inextricably intertwined” with the merger agreement’s defensive devices and were therefore actions by the board.¹⁰⁶ The court held they were board actions despite the fact that the two majority shareholders/directors agreed to the voting agreements in their shareholder capacity.¹⁰⁷ Applying the two-step analysis of *Unocal*, NCS’s directors were required to show that they acted in good faith after a reasonable investigation in order to establish they had reasonable grounds for believing a danger to corporate policy and effectiveness existed, and the danger here was the risk of losing Genesis’s offer without a comparable alternative.¹⁰⁸ To satisfy the second step the directors must “demonstrate that their defensive response was ‘reasonable in relation to the threat posed,’” which involves another two-step analysis requiring proof that the defensive devices were not coercive or preclusive, and then demonstrating the response was within a range of reasonableness.¹⁰⁹ The court then held that the defensive devices in the instant case were preclusive and coercive, based on a finding that NCS’s public shareholders would be forced to accept the Genesis merger (coercion).¹¹⁰ In addition, the lack “of an effective fiduciary out clause-made it ‘mathematically impossible’ and ‘realistically unattainable’ for the *Omnicare* transaction or any other proposal to succeed, no matter how superior the proposal” (preclusion).¹¹¹ Due to what the court deemed as the preclusive and coercive nature of the defensive devices, the majority then found that the devices were not within a reasonable range of responses to the perceived threat.¹¹²

Finally, the court focused on the fact that ‘an effective fiduciary out clause’ was not included in the merger agreement that would have allowed NCS to back out of the Genesis merger agreement if a better deal came along, thus allowing for an exercise of the board’s fiduciary

105. *Omnicare v. NCS*, 818 A.2d at 933-934 (citing *Mills Acquisition Co. v. Macmillan Inc.*, 559 A.2d 1261, 1288 (Del. 1988).)

106. *Id.* at 934.

107. *Id.*

108. *Id.* at 935, (citing *Unocal* 493 A.2d at 955).

109. *Id.* (citing *Unocal*, 493 A.2d at 955, *Unitrin*, 651 A.2d at 1387-1388.)

110. *Omnicare v. NCS*, 818 A.2d at 935-936.

111. *Id.* at 936.

112. *Id.* (citing *Unitrin*, 651 A.2d at 1388-1389).

responsibilities.¹¹³ This fiduciary out clause was required by the court because the court felt that the only way the board could represent the minority shareholders' interests was to maintain the power to terminate the merger agreement.¹¹⁴ The directors had a continuing obligation to exercise due care after the merger agreement was announced, and especially because the board agreed to defensive devices in anticipation of the probability of a subsequent superior offer, the board should have negotiated for a fiduciary out clause.¹¹⁵ Therefore, because the board "combined two otherwise valid actions" as a lockup without a fiduciary out clause in the Genesis merger agreement, the court held that NCS did not withstand *Unocal's* enhanced judicial scrutiny and reversed the Court of Chancery's holding which denied injunctive relief to Omnicare.¹¹⁶

III. ANALYSIS

a. *Why the Omnicare Majority Decision was Incorrect*

The majority of the Delaware Supreme Court incorrectly held that the NCS board's actions constituted a breach of fiduciary duty because the actions, in fact, did satisfy Delaware's requirements, and because the majority misapplied the applicable law.¹¹⁷ As noted above, most corporate management decisions are subject only to the business judgment rule. Courts exercise deference because they have determined that those who run corporations are in a better position than the judiciary to properly weigh all potential factors in reaching what reasonably appears to be the proper decision for the corporation at the time the directors or officers make a decision. Justice Steele noted in his dissenting opinion that courts have no business expertise qualifying them to substitute their judgment for an independent committee, for the board's cost benefit analyses, or for the independent decisions of majority shareholders.¹¹⁸ Courts may break from this deferential standard of review when directors act under a conflict of interest with the corporation or its shareholders,¹¹⁹ although no such conflict existed here. The majority's decision was incorrect because NCS' board's actions did in fact satisfy Delaware law, the majority

113. *Id.*

114. *Id.* at 937.

115. *Omnicare v. NCS*, 818 A.2d at 938.

116. *Id.* at 939.

117. See Section III(a)(i) for a discussion of the applicable Delaware law.

118. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 948 (Del. 2003) (Justice Steele's dissenting opinion).

119. *Id.* at 930.

misapplied the applicable law, and other jurisdictions lend support against the majority's holding.

i. The NCS Board's Actions Satisfied Delaware law

Unocal first noted that in the context of a *hostile* takeover, where directors utilize corporate funds as defensive devices to ward off a threat to control, there is an ever-present risk that the directors' decisions are skewed away from the proper interests.¹²⁰ *Unitrin* also supported the application of enhanced judicial scrutiny when a conflict of interest due to a potential loss of control occurs.¹²¹ However, the NCS board was not faced with a conflict due to a potential loss of control. Either Omnicare's or Genesis' merger offer would eliminate the directors' control over NCS,¹²² although the majority misguidedly cites *Unocal's* discussion of conflict of interest due to a loss of control as support for the argument that NCS faced a conflict of interest.¹²³

Justice Steele's dissenting opinion observed, "[t]he contract terms that NCS' board agreed to included no insidious, camouflaged side deals for the directors or the majority stockholders nor transparent provisions for entrenchment or control premiums."¹²⁴ Without a concern of a self-interested transaction, the directors, who also held stock, were left only with a concern for maximizing the value of their shares, indicating that they had the same vested interest as the shareholders in approving the merger deal providing the greatest value. This congruence of interests may be evidenced by the fact that when Omnicare's superior proposal subsequently arose, the NCS board withdrew its support of the Genesis deal, despite its agreement with Genesis to go forth with the merger.¹²⁵ Without a conflict of interest, the business judgment rule should apply and the court should defer to the directors in determining which business transaction is best for the corporation. There is a long line of jurisprudence providing that corporate decision-making devoid of any indication of conflict should be afforded a high degree of deference.¹²⁶ The use in this holding of en-

120. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

121. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, n9 (Del., 1995).

122. There was no indication in any of the quoted merger agreements that the directors would keep their control or board positions.

123. *Omnicare, Inc.*, 818 A.2d at 930 n27. (The Majority's reference is inappropriate because it cites *Unocal's* discussion of the "omnipresent specter" of a conflict of interest in the context of a "takeover bid" as opposed to the friendly merger offer in the instant action. *Unocal*, 493 A.2d at 954.)

124. *Id.* at 948. (Justice Steele's dissenting opinion)

125. *Id.* at 927.

126. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000); *Krasner v. Moffett*, 826 A.2d 277, 284 (Del. 2003).

hanced scrutiny without any conflicts of interest calls into question the validity of that entire line of jurisprudence. Even if there was a conflict of interest, the directors satisfied the requisite factors of *Unocal* and its progeny which should have resulted in the court's approval of the board's actions.

Assuming *arguendo* that an enhanced scrutiny applied, the court misapplied that standard. First, the board needed to show good faith and a reasonable investigation into the choices for merger and their ramifications. Both the Vice Chancellor and the Chief Justice found that all of the NCS directors clearly manifested "the care and attention given to this project by every member of the board."¹²⁷ To help insure the exercise of good faith, the board appointed an independent committee to evaluate the merger options and provide recommendations. It appears that the board followed all of the committee's recommendations, which were determined after weighing the risks and benefits of each company's merger offer.

Prior to *Omnicare*, Delaware law instructed a court to consider if a defensive device was reasonable in relation to the threat by examining if there were reasonable grounds to believe a danger to corporate policy existed. The review then turned to a two-tiered proportionality test, which first considered if the actions were draconian and then considered if they were within a range of reasonableness. NCS' board and Independent Committee had reasonable grounds to believe that without agreeing to Genesis' terms, there would be a danger to corporate policy. Without agreeing to the defensive devices "there would have been no Genesis deal!"¹²⁸ To provide any relief to its Noteholders and shareholders, NCS concluded that it required a merger. The search of the market for potential acquirers, performed in good faith while under the impending shadow of insolvency, only revealed two viable corporations, forcing NCS into a quandary. NCS could either face liquidation in *Omnicare*'s offered asset sale, or a Genesis merger providing advantageous terms but only upon acceptance of the defensive devices. Thus, Genesis' offer "appeared to be the only value-enhancing transaction available for a company on the brink of bankruptcy."¹²⁹ Genesis provided the only path to avoid potential liquidation, which would be the ultimate danger to corporate policy and effectiveness.

127. *Omnicare, Inc.*, 818 A.2d at 943 (Chief Justice Veasey's dissenting opinion, quoting *In re NCS Healthcare, Inc. S'holders Litig.*, 2002 WL 31720732 at *15 (Del. Ch. 2002)).

128. *Id.* at 941.

129. *Omnicare v. NCS*, 818 A.2d at 940.

NCS also had reasonable grounds for believing that Omnicare would only agree to an asset sale because after several negotiations, there was no indication Omnicare would discontinue its insistence on structuring the merger through bankruptcy. The only method in which to preserve a semblance of the current corporation and maximize shareholder value was to agree to the terms of the *only* other offer. The majority does not dispute that it was reasonable to believe Genesis would in fact walk away from the deal if NCS did not accept the defensive terms, and the dissent agreed that based upon Omnicare and Genesis' past relationship, it was reasonable to believe the Genesis ultimatum.¹³⁰

Once NCS demonstrated that it had reasonable grounds to believe such a danger existed, the test should have turned to the two-step proportionality test. First, NCS's protective devices were neither preclusive nor coercive. Preclusive methods restrict the shareholders right to receive offers.¹³¹ In the case at bar, the shareholders retained that right because the voting agreements, which for all practical purposes sealed the deal, were entered into by shareholders acting as shareholders. The fact that these shareholders were also directors does not equate to the actions being those of directors. The agreements specifically referred to Outcalt and Shaw as shareholders. Furthermore, Delaware cases have noted that shareholder-directors can act in their independent shareholder capacity.¹³² Moreover, the Independent Committee approved these shareholder agreements, thus providing uninterested, outside approval of the agreements without objecting to their characterization as shareholder agreements. Because the *shareholders* entered into these agreements, and the proportionality tests are intended to determine if the *directors* failed to exercise their fiduciary duties by forcing the shareholders into certain results without a say, the preclusive and coercive tests do not apply. Additionally, the shareholder agreements indicate that the shareholders supported the directors' actions. In fact, without the shareholder agreements, there could never have been a complete lock-up. The defensive devices were also not coercive because the shareholders were not forced into acquiescing to the merger. Besides the ability to refuse to enter into the shareholder agreements, appraisal rights were available to all shareholders who sought release from the merger agreement. Now

130. Omnicare, Inc., 818 A.2d at 941, n94.

131. *Id.* at 935 (citing Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989)).

132. *See*, H-M Wexford, LLC v. Encorp, 832 A.2d 129 (Del.Ch. 2003); Grimes v. Donald, 1995 WL 54441 at *9 (Del.Ch. 1995).

that it is evident that the actions were not draconian, the proportionality test should examine the range of reasonableness of the defensive devices.

To determine whether the actions taken were within a reasonable range, the court considered several factors, including the timing, impact on others, price, and the risk of non-consummation of the deal.¹³³ All of these factors weigh in favor of NCS' decision to accept the defensive devices. NCS was in a dire financial condition, and while its stock had begun to rise, NCS was still facing hundreds of millions of dollars of debt and insolvency. Additionally, the only other offer for relief through a merger threatened the very existence of NCS, and provided far less compensation to both the Noteholders and the stockholders. Finally, if NCS did not come to an agreement with Genesis, NCS would either lose the best offer they had received and expected to receive, and would then be forced to accept an exceedingly unfavorable offer. A finding that NCS acted outside of a reasonable range would force companies to choose far less attractive offers, and thus decrease the motivation for acquiring companies to offer better terms.

ii. The Omnicare Majority Misapplied the Applicable Law

In several key aspects, the majority misapplied Delaware law and failed to fully consider the relevant facts and circumstances. The majority noted that a conflict existed because the NCS board locked up the merger agreement with Genesis before the shareholders were allowed a final say over a potential future offer. However, the board members' interests were aligned with the shareholders' interests, because both would benefit from a superior offer since the board members also held shares. Furthermore, a corporation's shareholders ultimately decide who will serve on their board, thus the board would be motivated to obtain the highest possible shareholder value and greatest relief of the debt in order to demonstrate to the shareholders that the current board deserves their confidence.¹³⁴ Therefore, despite the majority's contrary holding, the goals of the board were consistent with those of the shareholders and Noteholders.

Additionally, if the board killed the far superior Genesis deal early on in the negotiations for failure to agree to the defensive devices, it may have constituted a breach of the board's fiduciary duty. Both

133. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del., 1985); *Mills Acquisition Co. v. Maxmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1988).

134. Admittedly, board members are typically elected by a few majority shareholders, however, the board members' large stock holdings serves as sufficient motivation to maximize the value of the shares.

decisions subjected the board to challenges of the manner in which it exercised its fiduciary duty, and the board simply chose the action that had the highest certainty for a beneficial outcome. That Omnicare finally did present an acceptable and superior deal after the fact should not render the board's proper exercise of its fiduciary duty irrelevant. "Rather, the NCS board's good faith decision must be subject to a real-time review of the board action before the NCS-Genesis merger agreement was entered into."¹³⁵ Determining the validity of an agreement based on subsequent unanticipated events will decrease confidence in otherwise valid agreements and provide a means for a competitor to use the courts to enforce a tardy bid that is just high enough over the agreement entered into by businesses operating in good faith. The majority also misinterpreted the shareholder agreements as actions by the board. As discussed in part III(a)(i), the shareholder agreements were just that, decisions individual shareholders made. The mere fact that the shareholders were also board members does not equate to the invalidity of the shareholders' actions.

The majority also improperly applied the draconian segment of the *Unitrin* proportionality test. First, the defensive devices were not enacted to fight off an *existing* hostile offer threatening the corporate policy and effectiveness, but only to prevent NCS from losing its only sufficient offer.¹³⁶ Second, while the board did agree to the measures, the measures originated from another outside party. It is illogical to state that the *board* coerced and precluded others, when in fact it was Genesis who demanded these defensive terms. *Unitrin* discussed the problems with draconian measures in the context of coercive and preclusive actions "initiated *by the board* to delay or retard an existing hostile bid. . ."¹³⁷ Lastly, as noted above, the board's actions could not coerce the shareholders into action or inaction where the shareholders had already made this a moot point by previously entering into the shareholder agreements.¹³⁸

Perhaps the most striking misapplication of Delaware law came in the application of the *Unitrin* proportionality test in evaluating the defensive devices. The court properly spoke of the *two*-step test, but once the majority determined that the defensive devices failed the draconian segment of the test, the court *automatically* found that that second part regarding the range of reasonableness failed as well sim-

135. Omnicare, Inc., 818 A.2d at 940 (Vealey, J., dissenting).

136. *Id.* at 943-944.

137. *Id.* at 944 (citing *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1379 (Del., 1995)).

138. *Id.* at 944-945.

ply because the measures were held to be draconian. The majority gave no justification for this drastic alteration of the proportionality test. By completely ignoring the second half of the test, the majority has indicated that this reasonableness query no longer has a place in Delaware's analysis of defensive devices. Such a strong rejection of precedent warrants some explanation.

Finally, the majority emphasized the lack of a fiduciary out clause, but ignored its own previous holding in the same opinion that the board holds a continuing fiduciary duty. The majority held that NCS board should have included a clause that permitted them to terminate the deal with Omnicare in order to exercise their fiduciary duty, yet they also held that the board's fiduciary duty continued after the announcement of the Genesis merger agreement.¹³⁹ However, it seems that a continuing fiduciary duty would make a clause, which allows the board to exercise the fiduciary duty it already holds, redundant. Another indication that the board was exercising the proper duty and properly considered any necessary future exercise of their fiduciary duty was the negotiation of a lower penalty if NCS broke the merger agreement. The penalty was decreased in exchange for agreeing to the defensive devices presumably because if the board thought that a future exercise of their duties were required, NCS should not be subject to as large of a penalty as previously suggested. Moreover, since the shareholder agreement prevented the subsequent deal, a future exercise of the board's fiduciary duty would not have prevented a Genesis merger, and a fiduciary out clause would have been completely ineffective. If the board exercised its authority under such a clause, it still would not have the power to order shareholders to breach their agreements with Genesis. The majority characterized the absence of a fiduciary out clause in addition to the shareholder agreements as impermissible lock-up agreements. However, lock up agreements are permissible in Delaware.

"A lock-up agreement is not *per se* illegal under Delaware law," and actually can maximize shareholder profit by encouraging higher bids.¹⁴⁰ A Delaware Chancery case factually similar to *Omnicare*, *Thompson v. Enstar Corp.*, upheld merger lock-up agreements, consisting of a voting trust agreement and by-law amendments required by the acquirer,¹⁴¹ against an action for preliminary injunction based

139. *Omnicare, Inc.*, 818 A.2d at 936, 938.

140. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 183 (Del., 1986) citing *Thompson v. Enstar Corp.*, 509 A.2d 578, 583 (Del. Ch., 1984). (Thompson does admit that lock-ups deserve careful scrutiny)

141. *Thompson v. Enstar Corp.*, 509 A.2d 578, 579 (Del. Ch. 1984).

on an application of the business judgment rule.¹⁴² The court emphasized that the board of the target company conducted an extensive search revealing only one bona fide offer, the value of the merger offer appeared to be the highest likely value at the time, and due to time constraints of the merger transactions, the directors were forced to act promptly to exercise their fiduciary duties.¹⁴³ Furthermore, the court held that to determine the reasonableness of the target board's actions, the current circumstances must be examined because "[t]he test of whether the [target] board acted reasonably. . . is not whether something happened. . . which, in hindsight, may show that the directors. . . should have delayed [their merger agreement]."¹⁴⁴

The majority should have recognized that the same holds true in *Omnicare*. "The adoption of the lock-up provisions was a necessary prerequisite to [the acquirer] making its tender offer and therefore it is probable it was reasonable for the directors to accede to [the acquirer's] demand under the unusual circumstances present."¹⁴⁵ While *Thompson* preceded both *Unocal* and *Unitrin*, and was decided in the context of a preliminary injunction, it is clearly parallel to the facts in *Omnicare*. Both cases involved an acquiring company requiring the board of the target company to agree to defensive devices in order to protect the bid, which provided the highest likely value for the target company. Not only did the *Thompson* court find that a diligent search and consideration of fair value was sufficient after careful scrutiny of the defensive devices, but it also held that the reasonableness of the board's actions should not be judged by future circumstances. The *Omnicare* majority misapplied Delaware law by ignoring this case and its holding, and by failing to consider other jurisdictions' treatment of the issues at bar.

iii. Other Jurisdictions

While it seems that *Omnicare* discussed a unique combination of the issues and facts discussed above, other jurisdictions can provide some guidance as to where the majority went wrong. First, it is clear that the *Unitrin* proportionality standard does require the court to examine whether a board's responses were reasonable in light of the threat to corporate policy and effectiveness after the court exams the board's actions for draconian measures.¹⁴⁶ Additionally, if a director

142. *Id.* at 581. (*Thompson* preceded both *Unocal* and *Unitrin*).

143. *Id.* at 581-582, 583.

144. *Id.* at 582.

145. *Id.* at 584.

146. *See, Burcham v. Unison Bancorp, Inc.*, 77 P.3d 130, 149 (Kan., 2003).

fails to carry his initial *Unocal* burden, his actions are not automatically invalidated, but instead the director has the burden to prove under judicial scrutiny that he exercised fair dealing and received a fair price under the entire fairness standard.¹⁴⁷ The Kansas Supreme Court also noted, “. . .invoking this rigorous standard would condemn most defensive tactics without any justification beyond the standard itself.”¹⁴⁸ Ohio agrees that where a board enters into a merger agreement and utilizes defensive devices, the business judgment rule will protect the actions as long as fraud, bad faith, or abuse of discretion does not arise; (“lock-ups in a takeover situation are not, *per se*, *ultra vires*.”)¹⁴⁹ As in Delaware, Ohio states that the failure to exercise due care after reasonable investigation or acting to satisfy a director’s own interests instead of the corporation or shareholders’, also may serve as grounds for the lock-ups to be deemed unlawful.¹⁵⁰

Regarding a potential conflict of interest, Maryland supports the notion that NCS’ directors were not acting under a conflict of interest even if they were offered board positions in the new company.¹⁵¹ Finally, Missouri law indicates that where a board considers merger offers, they need not take the highest offer; they “must simply accept the best alternative for shareholders, all things considered.”¹⁵² Similarly, Michigan holds that under the review of enhanced judicial scrutiny, the board’s decision need only be reasonable, not perfect, and the court should not second-guess a choice among merger alternatives based on subsequent events.¹⁵³

IV. THE AFTERMATH OF OMNICARE

a. *The Majority’s Decision May Be Somewhat Tolerable*

While appearing repugnant to logic and Delaware law, the majority’s holding may be tolerable in light of a narrow application and the

147. *Id.* (citing *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1371 (Del., 1995)).

148. *Id.* at 148 (quoting, Ronald J. Gilson & Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is there Substance to Proportionality Review?*, 44 *Bus. Law.* 247 (1989)) (This quoted passage also remarks that management is typically insulated by the business judgment rule from such a defensive response to a takeover bid as long as a hostile takeover is not involved which may cause a conflict of interest.)

149. *Stepak v. Schey*, 553 N.E.2d 1072, 1077 (1990), (citing *Cottle v. Storer Communication, Inc.*, 849 F.2d 570,574 (11th Cir. 1988)).

150. *Stepak*, 553 N.E.2d at 1077.

151. *Wittman v. Croke*, 707 A.2d 422, 425 (Md.App. 1998). (The court stated that employment offers do not constitute problematic conflicts of interest, especially if the transactions are disclosed to the shareholders prior to their ratification). *Id.*

152. *Flake v. Hoskins*, 55 F. Supp. 2d 1196, 1214 (D. Kan., 1999).

153. *Simon Property Group, Inc. v. Taubman Centers, Inc.*, No. 02-74799, 2003 US Dist. LEXIS 7435 at *52 (E.D. Mich., 2003).

recent trend away from deference to corporate management. As noted by both the majority and dissent, the facts of this case are fairly unique. It seems unlikely that the exact combination of insolvency, friendly merger, previous bad blood between the competing acquirers, number of provisions required to be accepted by shareholders and directors of the target corporation in a short period, and the subsequent higher offer by the former losing party found in the instant action will occur again. If the courts apply *Omnicare* to situations in which all of these circumstances are replicated, it is unlikely that *Omnicare* will often appear again.

The June 2003 issue of the M & A Lawyer suggests a number of methods courts may narrowly interpret and apply *Omnicare*.¹⁵⁴ First, Neimeth and Reese suggest that if a Section 251(c) covenant, requiring the board to submit merger proposals to the shareholders for a vote, is not included in a merger agreement, or included with a shareholder agreement that does not lockup a majority of the vote, a different result may occur.¹⁵⁵ Second, these mergers and acquisitions attorneys suggest that in exchange for agreeing to the acquiring company's defensive devices, the acquirer agrees to "fully fund[a]cash tender or registered exchange offer to cash (or swap) out the public minority" within a predetermined time of exercising the defensive devices.¹⁵⁶ Another offered alternative is to structure the "deal as a unilateral tender offer with a majority stockholder tender commitment. . . without a board approved merger agreement implicating the director approval and stockholder adoption requirements."¹⁵⁷ Among other suggestions, the article also notes that providing the special committee with complete authority to act on a deal could also possibly provide different results.¹⁵⁸

If future cases arise in which the directors do not provide as complete of a record of the numerous actions and considerations taken to render independent decisions, *Omnicare* may have some viability in analyzing defensive devices used carelessly without the appropriate weighing of the costs and benefits of each possible choice. Additionally, the decision may seem slightly less objectionable in view of the corporate controversies such as Enron and WorldCom of the past few years. These controversies have affected the reactions to corporate

154. Clifford E. Neimeth & Cathy L. Reese, *Locked and Loaded: Delaware Supreme Court Takes Aim at Deal Certainty*, 7 No. 2 M & A LAW. 16 (2003).

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

governance in both the public and judicial eye. Delaware Chief Justice Veasey remarked in January, 2003 that “a new set of expectations for directors [is] changing how the courts looks at these issues” and Delaware Vice Chancellor Strine stated “there’s increasing pressure on the courts to look at the subject of independent directors.”¹⁵⁹ In fact, the *Omnicare* decision followed four similar Delaware Supreme Court rulings which all reversed the lower court in favor of the shareholders.¹⁶⁰ After the recent corporate management controversies, the public and courts seem to be willing to accept more judicial intrusion upon the decision making of corporate directors and officers.

Finally, “[g]iven the unique facts of *Omnicare*, the powerful dissents, and the recent retirement of one of the majority justices, the full impact of the decision may need to await further judicial developments. In the meantime, the decision suggests that practitioners should approach very cautiously. . . deal protection measures.”¹⁶¹

b. *Impact of the Decision*

The majority’s decision appears to have a number of negative effects on corporate transactions throughout the country. More companies are incorporated in Delaware than any other state, so the odds are exceedingly high that one of several companies involved in a merger will be incorporated in Delaware and require Delaware law to apply to their transaction. Additionally, most states look towards Delaware’s corporate law decisions for guidance in their own holdings, so when a corporate decision making significant changes in previous jurisprudence is handed down by Delaware’s highest court, companies (and law firms) across the nation will listen and likely react.

Furthermore, other negative outcomes may result from *Omnicare*. The decision may cause potential bidders to offer lower prices, especially early in the negotiations for fear that higher offers cannot (or will not) be protected with any guarantee, and simply be used as a stalking horse to seek higher bidders to subsequently enter negotia-

159. Tamara Loomis, *Beware Delaware, The State’s Recent Supreme Court Decisions Make Waves*, 229 NEW YORK L. J. 5 (2003) (quoting Delaware Vice Chancellor Leo Strine at a corporate governance conference and quoting Delaware Chief Justice E. Norman Veasey).

160. *Id.* (citing *Telxon Corp. v. Meyerson*, 802 A.2d 257 (Del., 2002); *Saito v. McKesson HBOC Inc.*, 806 A.2d 113 (Del., 2002); *Levco Alternative Fund Ltd. v. Reader’s Digest Ass’n*, 803 A.2d 248 (Del., 2002); *MM Cos. v. Liquid Audio Inc.*, 813 A.2d 1118 (Del., 2003)).

161. ABA Subcommittee on Recent Judicial Developments, Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 58 BUS. LAW. 1521 (2003).

tions.¹⁶² “There are real life cases in which bidders turn away because they didn’t get lockup protection. . . .It’s a classic case of bad facts making bad law.”¹⁶³ It is reasonable to imagine other situations in which a bidding company has invested large amounts of money into acquiring a company and would like some concrete assurance that their good faith efforts are not completely in vain.

Just as early, high offers may be discouraged, the decision may encourage other bidders to wait out the negotiations of other parties and offer a slightly higher offer at the last possible moment. If the target corporation does not consider and possibly accept this twenty-fifth hour offer, despite other relevant factors outside of the higher price and contractual guarantees between the original negotiating parties, the target company exposes itself to significant litigation which it now has a high probability of losing. *Omnicare’s* trend away from considering all relevant factors of a bidder, besides the size of their wallet, may also result in more target companies losing their identity and entering bankruptcy or an asset sale. The dangers of ignoring the relevant circumstances surrounding a bidder’s offer are also abundant. It would seem advisable to encourage the corporate decision makers to evaluate more than just the highest price they may receive where they are deciding which companies will provide the highest likelihood of success. The decision suggests “that a board’s decision (however reasonable when made) is subject to post-hoc judicial rejection based on a superseding and unforeseen post-signing event.”¹⁶⁴ Thus, the holding makes a board’s decision-making process either not very relevant, or wholly irrelevant, based upon whether a somewhat improved “deal later comes along—even if that deal was not reasonably foreseeable at the time of the directors’ initial decision.”¹⁶⁵

Bankruptcy may often be the best solution for companies facing insolvency. However, until this holding, more options outside of bankruptcy existed for a board of directors to pursue in order to maintain some vestiges of the former company and return it to a financially viable position. All of the newly added uncertainty and lack of control over some of the most important events in a corporation’s life may cause more and more companies to simply avoid friendly mergers altogether and resign to enter bankruptcy or wait for a hostile takeover which they can only hope provides the financial relief a negotiated merger would have provided pre-*Omnicare*.

162. See Loomis, *supra* note 159 at 5.

163. *Id.* (quoting Robert Profusek, a partner at Jones Day in New York).

164. Neimeth & Reese, *supra* note 154 at .

165. *Id.*

V. CONCLUSION

The majority's holding in *Omnicare v. NCS Healthcare* was improper due to the failure to properly apply the facts and circumstances to the appropriate Delaware law and fully consider the ramifications of the holding. As it stands, the holding negatively impacts the free negotiation of parties wishing to effectuate a friendly merger, and calls into question the proper law across the United States for examining defensive devices. One can only hope that future courts treat this decision with the narrowest of application and correct its mistakes so that corporations may regain the proper level of confidence in business transactions when looking to Delaware for guidance in their actions.