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MERGERS & ACQUISITIONS ALERT

APRIL 8, 2011

California Appellate Court Holds That Boards of Directors May Enter into Exclusive Transaction Agreements – No "Fiduciary Out" Required

On March 30, 2011, the California Court of Appeal issued the first California state court decision affirming that the board of directors of a California corporation may lawfully enter into an exclusive agreement involving a recapitalization, merger or other extraordinary transaction without any requirement for a "fiduciary out". *Monty v. Leis*, No. B225646 (Cal. Ct. App. March 30, 2011). Orrick, Herrington & Sutcliffe LLP, led by securities litigation partner Daniel J. Tyukody, successfully represented the defendant directors in obtaining a denial of the preliminary injunction sought by the plaintiff shareholders, which denial was affirmed on appeal in *Monty v. Leis*.

Pacific Capital Bancorp ("PCB"), a public California corporation and the parent company of Pacific Capital Bank, N.A., was economically troubled and under pressure by federal regulators to improve its capital position or risk being seized and liquidated. Following an exhaustive year-long search for potential strategic or financial partners to enable PCB to satisfy its regulatory capital requirements, PCB entered into an exclusive investment agreement with Ford Financial Fund, LP ("Ford"), a fund affiliated with Gerald Ford, pursuant to which Ford would infuse the bank with $500 million of new equity capital in exchange for shares of common stock and preferred stock convertible into common stock at a 5000 to 1 ratio (collectively, the "Share Consideration"). Since the issuance of the Share Consideration was within PCB's previously authorized and unissued share capital and NASDAQ granted PCB a financial distress exemption to its shareholder vote requirements, the proposed recapitalization transaction did not require any PCB shareholder vote. Moreover, the issuance of the Share Consideration in the transaction would provide Ford the majority voting power necessary to unilaterally approve a post-recapitalization amendment to PCB's articles of incorporation to authorize sufficient additional shares of common stock to accommodate the conversion of the preferred stock portion of the Share Consideration. Following the completion of the recapitalization transaction, Ford would hold a combined equity interest in PCB of between 80 and 91 percent on an as-converted basis, depending on the level of subscriptions from existing shareholders in a concurrent rights offering.

Two PCB shareholders brought an action against PCB and its board of directors seeking to enjoin the transaction as, among other things, an improper abdication by the PCB board of its fiduciary duties based on its failure to include in the investment agreement a "fiduciary out" provision that would allow the PCB board to back out of the deal if a better offer was made. In support of this proposition, the PCB shareholders cited the Delaware

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Supreme Court's decision in *Omnicare*[1] for the proposition that an investment agreement must contain such a way out. Specifically, the PCB shareholders analogized the combination of Ford's unilateral voting power in the PCB recapitalization transaction and the absence of any "fiduciary out" as creating the very type of *fait accompli* that the Delaware Supreme Court rejected as impermissible in *Omnicare*.

However, in its ruling in *Monty*, the California Court of Appeal specifically declined to follow *Omnicare*, citing the fact that it has been criticized even by Delaware courts. Instead, the California Court of Appeal adopted the reasoning in *Jewel,*[2] the only reported case interpreting protective measures under California law, which held that "under California law a corporate board of directors may lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers until the shareholders have had an opportunity to consider the initial proposal." Because "a potential merger partner may be reluctant to agree to a merger unless it is confident that its offer will not be used by the board simply to trigger an auction for the firm's assets" and "therefore, an exclusive merger agreement may be necessary to secure the best offer for the shareholders of a firm," the *Jewel* court held that a board of directors will not breach its fiduciary duty by failing to include a "fiduciary out" provision in a merger agreement. Even though a better offer may be presented after the exclusive merger agreement is executed, the *Jewel* court further reasoned that "all contracts are formed at a single point in time and are based on the information available at that moment" and "the pursuit of competitive advantage has never been recognized at law as a sufficient reason to render void, or voidable, an otherwise valid contract." Thus, a board has no duty to include in a merger agreement a mechanism allowing the company to back out of a deal upon receipt of a better offer and does not breach its fiduciary duty by granting exclusivity. The California Court of Appeal concluded in *Monty* that the same reasoning applied to the PCB/Ford investment agreement and, therefore, the PCB board had no duty to include a "fiduciary out" in that agreement.

The *Monty* case is significant in that it constitutes the first California appellate law precedent to clearly establish that boards of directors of California corporations have no duty to include a "fiduciary out" in extraordinary corporate transaction agreements despite fiduciary duties jurisprudence in Delaware and other prominent jurisdictions that might suggest otherwise. As such, perhaps to the delight of the *Omnicare* dissenters, boards of directors of California corporations remain free to consider the granting or withholding of exclusivity as simply one of many deal protection measures to be thoughtfully examined in discharging their fiduciary duties in the context of extraordinary corporate transactions.

In a decision that will likely have a substantial impact on the disclosure of financial advisor's fees and post-closing executive employment arrangements in merger transactions, *In re Atheros Communications, Inc. Shareholder Litigation*, C.A. No. 6124-VCN (Del. Ch. 2011), the Delaware Court of Chancery, on March 4, 2011, enjoined the stockholders' meeting of Atheros Communications, Inc. called for March 7, 2011 to approve the proposed $3.1 billion cash merger of Atheros with Qualcomm Incorporated.

The Court issued a preliminary injunction based on its conclusion that the Atheros proxy statement inadequately disclosed both: (i) the nature and amount of the fees to be paid to Atheros' financial advisor, Qatalyst Partners, L.P., in connection with the merger, and (ii) the timing and nature of discussions between Qualcomm and Atheros' Chief Executive Officer, Craig Barratt, regarding Barratt's continuing employment with Qualcomm after the completion of the merger. The Court ordered Atheros to make corrective disclosures in a supplemental proxy statement before proceeding with a stockholder meeting to vote on the merger.

The Court's conclusions regarding the disclosure of the fees of financial advisors and post-closing management employment arrangements will likely require practitioners and clients to examine closely, and consider changing, current disclosure practices, and to pay special attention to the disclosure of discussions regarding post-closing employment or other arrangements benefitting management.

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[1] In *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), the Delaware Supreme Court held, in a narrow 3-2 decision, that the combination of (a) an ineffective fiduciary out provision, (b) a "force the vote" provision mandating a shareholder vote even if the board withdrew its recommendation to the shareholders to approve the merger and (c) voting agreements that required majority shareholders to vote in favor of the merger, is unenforceable.

[2] *Jewel Cos. v. Pay Less Drug Stores Nw., Inc.*, 741 F.2d 1555 (9th Cir. 1984)

Disclosure of Financial Advisor Fees

Atheros has maintained a strategic partnership with Qualcomm since 2005 and began preliminary discussions regarding a possible transaction in mid-2010. Atheros retained Qatalyst (the "Financial Advisor") as its financial adviser in the fall of 2010, but the final engagement letter was not executed between Atheros and the Financial Advisor until December 28, 2010, shortly before the merger agreement was executed. The engagement letter provides that the Financial Advisor will receive a flat fee, two percent of which would be payable upon the Financial Advisor's delivery of a fairness opinion regarding the proposed transaction and 98 percent of which would be payable only if the transaction closed.

The Financial Advisor delivered to the board of directors of Atheros its opinion that the proposed transaction with Qualcomm "is fair, from a financial point of view" to the Atheros stockholders and that fact was disclosed in the proxy statement distributed to Atheros' stockholders prior to the stockholders meeting called for the approval of the merger. However, as is commonly the case in merger transactions, the proxy statement did not disclose the exact amount of the Financial Advisor's fee or the exact percentage of the fee that was contingent upon a closing of the merger. The proxy statement merely informed Atheros' stockholders that the Financial Advisor would "*be paid a customary fee, a portion of which is payable in connection with the rendering of its opinion and a substantial portion of which will be paid upon completion of the Merger*."

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