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MERGERS & ACQUISITIONS ALERT

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Delaware Court Enjoins Pending $3.1 Billion Merger Due to Inadequate Disclosure Regarding Financial Advisor's Fees and CEO Employment Arrangements

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.

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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The Court began its analysis by noting that "financial advisors . . . serve a critical function by performing a valuation of the enterprise upon which its owners rely in determining whether to support a sale." The Court stated that therefore, "[b]efore shareholders can have confidence in a fairness opinion or rely upon it to an appropriate extent, the conflicts and arguably perverse incentives that may influence the financial advisor in the exercise of its judgment and discretion must be fully and fairly disclosed."

Applying this requirement to the disclosure provided by Atheros, the Court concluded that the plaintiffs demonstrated a reasonable probability of success on their claim that the disclosure of the contingent fee arrangement by which the Financial Advisor will be compensated is inadequate. The Court stated as follows:

> 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". . . The differential between compensation scenarios may fairly raise questions about the financial advisor's objectivity and self-interest. . . . In essence, the contingent fee can readily be seen as providing an extraordinary incentive for [the Financial Advisor] to support the [merger]. Those facts which reasonably may be understood by the stockholders to raise doubts about the independence and objectivity of [the Financial Advisor] should be disclosed.

The Court went on to state that Atheros would be required to disclose the amount of fees it is paying to the Financial Adviser, but declined to declare a general rule requiring such disclosure in all cases, stating that "[t]he parties debate whether the amount of a financial advisor's fee needs to be disclosed or whether merely disclosing that the fee is customary (which it is in this instance) suffices. It is not necessary to resolve that general debate here. Given the late agreement between Atheros and [the Financial Advisor] as to financial advisor compensation, coupled with the contingent fee concerns set forth above, the stockholders should be afforded an opportunity to understand fully the nature and means by which Atheros will compensate [the Financial Advisor]. Thus, that would include the amount of the fee as well."

Disclosure of Post-Closing CEO Employment Arrangements

The proxy statement stated that before December 14, 2010, "[Atheros CEO and director] Dr. Barratt had not had any discussions with Qualcomm regarding the terms of his potential employment by Qualcomm." The proxy statement did not disclose that Barratt knew—at some point before that date—that he would be employed by Qualcomm after closing. The plaintiffs also argued that emails exchanged between Qualcomm's chief negotiator and Barratt in the middle of November 2010 concerning the treatment of employee stock options and other related equity awards, indicate that terms of Barratt's future position with Qualcomm were discussed before December 14, 2010.

The Court noted that the defendants did not dispute that Barratt understood, sometime before December 14, 2010, that he would have a job with Qualcomm after closing. But defendants did contend that, before that date, management had not engaged in anything more detailed than general "initial exploratory discussions" regarding Qualcomm's treatment of the many Atheros employees it was considering retaining after the merger closed. Specifically, defendants asserted that no discussions occurred regarding the particular terms of Barratt's potential employment with Qualcomm before December 14.

The Court concluded that under the circumstances, the disclosure regarding Barratt's post-closing employment arrangements was inadequate, stating that "[k]nowledge that, even though specific terms were not elicited until later in the process, Barratt was aware 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."

The curative disclosure required by the Court is for Atheros to disclose in supplemental proxy materials the date on which Barratt learned from Qualcomm that it intended to employ him after the merger closed.

Implications for Current Practice

As noted above, this decision is significant because the Court imposed the remedy of enjoining the pending stockholder vote, thereby delaying the closing of the merger and exposing the parties to an increased risk of non-consummation, until such time as corrective disclosure can be made and distributed to stockholders. The Court described the resulting delay as "short" and Atheros has distributed its supplemental proxy reconvening the meeting for March 18, 2011, eleven days after the original meeting date. But obviously any material delay of a transaction creates additional risk that intervening events may disrupt a contemplated closing.

If the Securities and Exchange Commission staff reviews a proxy statement, Form S-4 registration statement, Schedule TO or Schedule 14D-9, it will routinely require detailed disclosure of the financial advisors' fees. Nevertheless, it is a common practice for parties to submit materials that merely disclose that "customary fees" will be paid and that a "substantial portion" of such fees are contingent upon the closing of the transaction, in hopes that, in the absence of SEC staff review, such a vague description can be retained in the final disclosure documents.[1] In light of the *Atheros* decision, this practice will need to be carefully reviewed by parties and their advisors engaging in business combinations. The now thoroughly demonstrated risk that a closing can be enjoined for failure to fully disclose financial advisors' fees will need to be weighed against the interests of the parties and financial advisors in maintaining confidentiality regarding the exact amount of their fees.

In addition, in the area of senior executive employment arrangements, it is now abundantly clear that the Delaware Courts will be very demanding in requiring thorough disclosure regarding all discussions of such arrangements, which they regard as highly material to stockholders' evaluation of a sale process. Reticence in disclosing the discussion regarding such arrangements has now been proven to present substantial risks to the timely closing of business combination transactions.

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[1] See, for example, SEC Comment Letter to McAfee, Inc. dated September 10, 2010; SEC Comment Letter to Ebix, Inc. dated November 10, 2010 and SEC Comment Letter to AMICAS, Inc. dated January 13, 2010.