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Paying for the Privilege of Independence: Termination Fees Triggered by "Naked No Votes"

The Delaware Chancery Court has never given clear guidance on the use of termination fees triggered by "naked no votes." These occur when a target's stockholders reject a merger agreement in the absence of an alternative or superior transaction. The Court has, however, made some statements that are instructive.

by John Mark Zeberkiewicz and Blake Rohrbacher

In this article we revisit the proposed Lear–Icahn merger discussed in the July issue of *Insights* in our article titled "The Shops Are Open: Delaware's New Take on Go-Shop Provisions Under *Revlon*."[1] Specifically, we discuss the termination fee that was added to the Lear–Icahn merger agreement and, in light of that provision, we review the implications of, and the Delaware courts' statements about, termination fees triggered by "naked no votes." A "naked no vote" occurs when a target's stockholders vote to reject a merger agreement in the absence of an alternative or superior transaction.[2] In some cases, buyers will negotiate to protect against this risk and will seek to include in the merger agreement a provision requiring the target to pay a fee (usually much lower than the full break-up fee) upon the occurrence of a naked no vote.

This type of termination fee trigger has been relatively rare, at least in the realm of deals involving publicly traded targets.[3] The Delaware Court of Chancery has never given clear guidance on its use. Considering that a naked-no-vote termination fee was paid in the Lear-Icahn merger (a high-profile, closely watched transaction) and that buyers may begin to demand protection against a naked no vote with greater frequency, deal planners may benefit from a focused look at what the Delaware courts have said about these fees. The following discussion of naked-no-vote fees refers to all fees payable upon the occurrence of a naked no vote, including full termination fees, partial termination fees, and expense reimbursements.

Recent Events in the Lear–Icahn Merger Transaction

The background facts regarding Carl Icahn's attempted takeover of Lear Corporation were set forth in our July article and in the Court of Chancery's June 15 opinion on the matter.[4] Briefly, after purchasing roughly 24 percent of Lear's stock at a range of $16 to $23 per share, Icahn indicated in January 2007 that he might be willing to take

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Lear private.[5] Icahn initially offered to acquire Lear at $35 per share, which the CEO and a special committee rejected as inadequate, and then raised his bid to $36 per share. Lear and Icahn negotiated a deal protection package that included a 45-day "closed" go-shop period, a match right, a two-tiered termination fee tied to the go-shop period, and a reverse break-up fee.[6] Plaintiffs moved to preliminarily enjoin the merger, arguing that Lear's board had breached its *Revlon* duties and failed to disclose certain material facts. The Court denied plaintiffs' motion as to the *Revlon* claims, finding that, although Lear's board had caused the company to enter into a merger agreement without engaging in a full pre-signing auction, the plaintiffs were unlikely to succeed on those claims.[7] The Court also issued a preliminary injunction preventing the vote on the merger until certain supplemental disclosure was made regarding the negotiations between Lear's board and its CEO over his retirement plans and equity stake.

The Court's opinion was issued on June 15. Icahn subsequently offered to increase his bid to $37.25 per share, and on July 9 the parties amended the merger agreement to reflect the increased price. Perhaps sensing that the deal, even with the sweetened bid, was at risk of being scuttled,[8] Icahn negotiated to include in the amendment a termination fee in the amount of $12.5 million in cash and 335,570 shares of Lear stock payable upon a naked no vote from the Lear stockholders.[9] Some of Lear's large stockholders publicly criticized the naked-no-vote termination fee as coercive,[10] but no challenge was raised.[11]

On July 16, the Lear stockholders voted and rejected the Icahn merger agreement.[12] This vote alone entitled Icahn to payment of $12.5 million in cash and 335,570 shares of Lear stock (valued at nearly $12.5 million on July 17). In short, in exchange for increasing his bid, Icahn received $25 million when Lear's stockholders retained their independence by rejecting his offer.[13] This result is even more surprising than it may seem. The Lear stockholders' "no" vote apparently "marked only the eighth U.S. deal that shareholders have nixed in a vote since 2003, . . . out of more than 1,000 deals requiring approval."[14]

Termination Fees on Naked No Votes

The naked-no-vote termination fee paid in the Lear–Icahn transaction may have been the most prominent in recent memory, but it assuredly will not be the last. In a study of "97 acquisition agreements for acquisitions of U.S. publicly traded target companies by publicly traded and other strategic acquirers for calendar year 2004," 13 percent of the deals included a fee of some kind triggered by a naked no vote.[15] There were 11 transactions total; "nine required reimbursement of expenses only, one required payment of [a] full break-up fee and one required payment of a partial break-up fee."[16]

Though naked-no-vote termination fees have been present in the deal world for several years, the Delaware courts have as of yet said very little about them. The fee in the Lear–Icahn transaction was added to the merger agreement after the Court of Chancery issued its opinion in *Lear*, so the Court said nothing about it.

In no opinion has the Court of Chancery held that a naked-no-vote termination fee is reasonable or unreasonable under *Revlon*[17] or any other standard of review. Its comments on such fees have been minor asides or oblique references, but these comments suggest that the Court of Chancery is not unaware of these fees and will be prepared to address them when the issue arises. One early reference to a naked-no-vote fee appeared in 1996, when the Court in *Emerson Radio* was describing the post-auction negotiations between target International Jensen and potential acquirer Emerson Radio.[18] The Court noted that among Emerson's proposals unacceptable to Jensen was "Emerson's insistence that Jensen pay Emerson a termination fee in the (highly likely) event that Jensen shareholders did not vote for the Emerson merger. Because Jensen was insisting that Emerson bear the risk of Jensen's shareholders disapproving a Jensen/Emerson merger, that . . . condition was especially problematic [to Jensen]."[19]

The *Emerson Radio* comment reveals an intriguing aspect of naked-no-vote fees: They involve the target directors' decision to impose a fee on their own stockholders if the stockholders reject the merger agreement approved by the directors. That

is, the fee in some respects serves as a penalty on the stockholders for not following their directors' advice.[20] The Court has in fact made a comment falling vaguely along this line. In 2000, when discussing employment agreements (with generous severance packages) executed with management in part to provide "negotiating leverage with potential acquirors," the Court in *Hills Stores* stated that "a termination fee payable in the event of a negative stockholder vote on a merger places the same sort of economic toll on the franchise as the Employment Agreements."[21]

In *McMillan v. Intercargo Corp.*, another 2000 Chancery case, the Court again made a passing comment on naked-no-vote fees.[22] The termination fee in *McMillan* was not a naked-no-vote fee; it "was structured so as to be payable only in the event that the Intercargo [target] stockholders rejected the XL merger and were benefited by a more favorable strategic transaction within ninety days or another acquisition proposal within the ensuing year."[23] The Court held the fee reasonable, stating that "[t]his structure ensured that the Intercargo stockholders would not cast their vote in fear that a 'no' vote alone would trigger the fee; the fee would be payable only if the stockholders were to get a better deal."[24] The *McMillan* Court thereby appeared to suggest that one of the redeeming factors of the termination fee in that case was that it was *not* a naked-no-vote fee (which would have caused the target's stockholders to "vote in fear"). The Court's glancing reference to the fear-inspiring naked-no-vote fee, however, should not necessarily be construed to mean that the Court categorically disfavors such fees. The context in which the Court made this comment involved a termination fee that was "at the high end of what our courts have approved, [though] still within the range that is generally considered reasonable."[25] It is unlikely that the Court meant to suggest that naked-no-vote fees are unreasonable in all circumstances, though it may be inferred that the Court would likely find such a fee to be unreasonable when it is as high as a (high) full termination fee.

Five years later, the Court of Chancery sounded a more hopeful note on naked-no-vote termination fees. In *Toys 'R' Us*, the Court finally faced a naked-no-vote fee—the target had "agreed to pay only up to $30 million in documented expenses" upon the occurrence of a naked no vote.[26] For purposes of comparison, the full termination fee, "payable for the most part only if the Company terminated the merger agreement in order to sign up another acquisition proposal within a year," was $247.5 million (3.75 percent of equity value and 3.25 percent of enterprise value).[27] Though the Court did not scrutinize the naked-no-vote fee in its opinion, it did make an interesting statement regarding the fee. "[T]he bottom line is that the public stockholders will have an opportunity tomorrow to reject the merger if they do not think the price is high enough in light of the Company's stand-alone value and other options. If the stockholders vote no, the only price will be the payment of $30 million to [potential acquirer] KKR Group, which is likely less than its actual expenses to date."[28]

The *Toys 'R' Us* Court, therefore, seemed to view the naked-no-vote fee with some approval. It is possible that, because the naked-no-vote fee was all that the target company would pay(there was no other acquisition proposal), the Court saw the naked-no-vote fee as a cheap price to pay for the target stockholders' freedom. It was, after all, less than half of a percent of the equity or enterprise value of the transaction.[29]

Conclusion

While the Court of Chancery's pronouncements on naked-no-vote termination fees have not been particularly clear or substantial, the Court has taken note of such fees and is likely to scrutinize them in the future. Although prevailing practice so far suggests that naked-no-vote fees are typically expense-reimbursement provisions (though the Lear–Icahn fee was not such[30]) and are typically much smaller than full termination fees,[31] deal planners should be aware that the precise parameters of such fees have not yet been determined by the Delaware courts.

NOTES

1. John Mark Zeberkiewicz & Blake Rohrbacher, "The Shops Are Open: Delaware's New Take on Go-Shop Provisions Under Revlon," *Insights*, July 2007, at 2.

Two other transactions were discussed in that article. We have no further events to report in the acquisition of Vertrue Incorporated by an

investor group consisting of One Equity Partners, Oak Investment Partners, and Rho Ventures. This acquisition was discussed in *Berg v. Ellison*, C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (TRANSCRIPT). In the Topps transaction, discussed in *In re The Topps Co. S'holders Litig.*, — A.2d —, 2007 WL 1732586 (Del. Ch. June 14, 2007), the parties have continued to act. On June 25, Upper Deck launched a tender offer at the $10.75 per-share price it had offered earlier. "Playing Its Cards: Upper Deck Begins an Offer for Topps," *Wall St. J*., June 26, 2007, at C2. On July 9, Topps urged its stockholders to reject the Upper Deck tender offer, stating that it planned to continue talks with Upper Deck. Anthony Buccino, "Topps Urges Rejection of Bid by Upper Deck," *Wall St. J*., July 10, 2007, at B7.

2. A termination fee tied to the occurrence of a naked no vote could be payable in either of the following scenarios: (1) the target's board continues to recommend that the stockholders adopt the merger agreement, but the agreement is not adopted by the requisite stockholder vote, and (2) the board modifies or withdraws its recommendation in a manner adverse to the buyer, the buyer nevertheless declines to terminate the agreement as a result thereof, and the agreement is submitted to the stockholders under a "force-the-vote" provision permissible under 8 *Del. C.* § 146 but is not adopted by the requisite stockholder vote.

3. *See* Keith A. Flaum, "First Annual Deal Points Study—Public Targets," *M&A Law*., May 2006, at 3, 6 (noting that only 13 percent of 2004 deals with publicly traded targets involved a naked-no-vote trigger). *But see* M & A Market Trends Subcommittee, Section of Business Law, Am. Bar Ass'n., "2007 Private Equity Buy or/Public Target Mergers and Acquisitions Deal Points Study" 40 (2007) (finding that 47 percent of 2005 and 2006 acquisitions of publicly-traded targets by private equity acquirers involved naked-no-vote triggers.

4. *In re Lear Corp. S'holder Litig.*, — A.2d —, 2007 WL 1732588 (Del. Ch. June 15, 2007); Zeberkiewicz & Rohrbacher, *supra* n.1, at 2**.**

5. *Lear*, 2007 WL 1732588, at *3–4, *6.

6. *Id.* at *12–13. A "closed" go-shop allows the target company to shop the company freely for a specified period , looking for a better deal, but only allows for a reduced termination fee if a competing bidder enters into a definitive agreement within the go-shop period; a match right provides that the initial bidder will have a chance to match the bid of a competing bidder; a two-tiered termination fee allows the target company to pay a lower fee if it terminates the merger agreement during the go-shop period (or, in some cases, enters into an agreement with a party identified during the go-shop period); and a reverse break-up fee is generally payable by the initial bidder to the target company in the event that the initial bidder breaches the merger agreement.

7. *Id.* at *1–2.

8. Shareholder-advisory firm Institutional Shareholder Services had recommended that Lear's stockholders vote against Icahn's $36 bid. John D. Stoll & Stephen Wisnefski, "ISS Recommends Lear Holders Reject Icahn Bid," *Wall St. J.*, June 21, 2007, at A12.

9. Lear Corporation, Proxy Statement (Form DEFA14A), at Annex A, § 2.02 (July 9, 2007). Prior to the amendment, Icahn was entitled to receive a termination fee upon the occurrence of a "no" vote by Lear's stockholders only if the "no" vote was followed by (i) the entry by Lear into a definitive agreement with respect to an acquisition proposal with 12 months after the termination and the transaction's completion, and (ii) the approval by Lear's stockholders of the transaction within that 12-month period (if required by law). Lear Corporation, Proxy Statement (Form DEFM14A), at A-48, A-50 (May 23, 2007).

10. Terry Kosdrosky, "Icahn Loss May Be a Watershed," *Wall St. J.*, July 17, 2007, at A2.

11. Interestingly, the merger agreement provided that an identical fee would be payable if a court were to issue an order preventing the naked-no-vote fee from being paid. Lear Corporation, Proxy Statement (Form DEFA14A), at Annex A, § 2.03 (July 9, 2007).

12. Kosdrosky, *supra* n.10.

13. Icahn will still be entitled to a full termination fee (which includes provision for Icahn's reasonably documented expenses up to $15 million) if Lear enters into a deal within the next 12 months, but the amendment decreased the total termination fee payable upon securing a superior proposal by the amount deemed to have been paid upon the stockholders' naked no vote. Lear Corporation, Proxy Statement (Form DEFA14A), at Annex A, § 2.07 (July 9, 2007).

14. Terry Kosdrosky, "Lear Vote Is Big Bet on Detroit," *Wall St. J.*, July 17, 2007.

15. Flaum, *supra* n.3, at 4, 6.

16. *Id.* at 6 (italics omitted).

17. Generally speaking, under *Revlon*, once a board has decided to sell the company, the board's duties involve "getting the best price for the stockholders." *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). Delaware courts scrutinize the process by which boards enter into and finalize merger agreements to determine whether the boards have fulfilled those duties.

18. *Emerson Radio Corp. v. Int'l Jensen Inc.*, 1996 WL 483086 (Del. Ch. Aug. 20, 1996).

19. *Id.* at *9.

20. If, however, the board has modified or withdrawn its recommendation in a manner adverse to the buyer, but has submitted the merger agreement to the stockholders under a force-the-vote provision permissible under 8 *Del. C.* § 146, the stockholders will be penalized for not following the board's *initial* decision to enter into the merger agreement.

21. *Hills Stores Co. v. Bozic*, 769 A.2d 88, 103–04 (Del. Ch. 2000).

22. *McMillan v. Intercargo Corp.*, 768 A.2d 492 (Del. Ch. 2000).

23. *Id.* at 505.

24. *Id*.

25. *Id*.

26. *In re Toys 'R' Us, Inc. S'holder Litig.*, 877 A.2d 975, 997 (Del. Ch. 2005). Interestingly, *Toys 'R' Us* was decided by Vice Chancellor Strine, as was *McMillan* and *Hills Stores* (and *Lear*). *Emerson Radio* was decided by then-Vice Chancellor (now Justice) Jacobs.

27. *Id*.

28. *Id.* at 1023.

29. The naked-no-vote termination fee in the Lear–Icahn transaction was roughly 9/10 of a percent of the equity value and roughly 6/10 of a percent of the enterprise value.

30. *See supra* n.13.

31. *See* M&A Market Trends Subcommittee, Section of Business Law, Am. Bar Ass'n, First Annual Public Target M&A Deal Points Study 52 (2006), available at *http://www.ipba.org/calendar/documents/5d_Wilson_Chu_Public_Target_M&A_Deal_Points_Study_(version_3Apr06).pdf* (seeming to suggest that "3% of the aggregate transaction value" is acceptable for a termination fee payable upon a "no" vote accompanied by an alternative acquisition proposal, while "1% of aggregate transaction value" is acceptable for a fee payable upon a naked "no" vote); *see also Flaum*, *supra* n.3, at 6 (noting that, in the deal sample analyzed, "full break-up fees are almost unheard of in that context," though planners "sometimes see expense reimbursement provisions in the event of a 'naked no'").

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