Re: Recent Delaware Corporate Law Decisions

During the past few months, the Delaware courts have issued several opinions that raise important issues for Delaware corporations and their advisors. In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, the Court of Chancery rejected the argument of a buyer that the target company experienced a material adverse effect, found that the buyer had "knowingly and intentionally" breached the merger agreement, and, as a result, ordered the buyer to specifically perform its obligations under the merger agreement. In *McPadden v. Sidhu* and *In re Lear Corp. Shareholders Litigation*, the Court of Chancery revisited the issue of directors' duty of good faith in the wake of the *Ryan v. Lyondell* decision, and in each case granted motions to dismiss for failure to state a claim. In *In re Loral Space & Communications Inc. Consolidated Litigation*, the Court of Chancery held that a stockholder's imposition of a significant preferred equity financing transaction on the corporation failed to meet the entire fairness standard based largely on deficiencies in the special committee formed to negotiate the transaction and terms that were deemed to be unfairly advantageous to the stockholder. Finally, in *AT&T Corp. v. Lillis*, the Delaware Supreme Court remanded to the Court of Chancery for further consideration of the issue of whether option holders were entitled to receive additional consideration reflecting the time value of their options in a cash-out merger. Following remand, the Court of Chancery determined that, in its trial opinion, it did not take into account the distinction between treatment of options in stock-for-stock mergers and cash-out mergers.

Court of Chancery Rejects Argument that Target Company Suffered a Material Adverse Effect and Orders Specific Performance of Merger Agreement

In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008), the Court of Chancery in a post-trial opinion rejected the argument of acquirer Hexion Specialty Chemicals, Inc. ("Hexion") that the deteriorating financial situation of the target company, Huntsman Corporation ("Huntsman"), amounted to a material adverse effect ("MAE"), and found that Hexion "knowingly and intentionally" breached the merger agreement. Accordingly, the Court ordered Hexion to specifically perform its obligations under the merger agreement.

The litigation arose out of a $10.6 billion all-cash deal entered into in July 2007, in which Hexion agreed to acquire 100% of Huntsman's common stock. In May 2007, Huntsman began soliciting bids for the company, and Hexion and Basell emerged as the two final bidders. In June 2007, Huntsman executed a merger agreement with Basell for $25.25 per share, but terminated the agreement when Hexion increased its offer to what became the final terms—a $28 per share cash transaction. Because the transaction arose from this competitive "deal jump" situation, Huntsman was able to extract "more than usually favorable" deal terms. For instance, the merger agreement did not include a "financing out," and therefore Hexion would not be excused from performance if it was unable to obtain financing by closing. Moreover, the agreement required Hexion to use its "reasonable best efforts" to take all actions "necessary, proper or advisable" to secure financing for the transaction, and prohibited Hexion from taking any action that could "materially impair, delay or prevent consummation" of the financing. Finally, the agreement provided that if Hexion committed a "knowing and intentional breach of any covenant," damages would be uncapped, while damages for any other breach of the merger agreement would be subject to a $325 million liquidated damages cap.

In April 2008, Huntsman reported disappointing first quarter results. Soon after it received Huntsman's updated financial information, Hexion began to explore two main options for terminating the transaction: (i) the possibility that the decline in Huntsman's financial situation constituted an MAE and (ii) the possibility that the post-merger entity would be insolvent, which Hexion believed would dissuade its lenders from providing the financing necessary to close the transaction. Hexion retained a valuation firm to analyze the financial standing of the combined entity, and ultimately asked the firm to provide a formal opinion that the combined entity would be insolvent. Hexion later published this "insolvency" opinion in a press release and circulated the opinion to its lenders.

In June 2008, Hexion filed suit, seeking declaratory judgment that (i) Huntsman had suffered an MAE, which permitted Hexion to terminate the transaction; (ii) Hexion had not committed a "knowing and intentional breach" of its obligations under the agreement, and therefore its liability for failing to close the merger was limited to the $325 million liquidated damages cap; and (iii) Hexion was not obligated to close the transaction if the combined entity would be insolvent. Huntsman filed counterclaims alleging that, by circulating the "insolvency" opinion to its lenders, Hexion "knowingly and intentionally" breached the merger agreement, and seeking an order granting specific performance of the merger agreement.

Under the merger agreement, an MAE was defined as "an occurrence, condition, change, event, or effect that is materially adverse to the financial condition, business or results of operations of [Huntsman]." This definition was subject to certain carveouts for circumstances such as "general economic or financial market conditions," and conditions affecting the chemical industry generally, except to the extent that such conditions had a disproportionate effect on Huntsman. Pointing to this second carveout, Hexion argued that Huntsman's financial decline, when compared to its chemical industry peers, amounted to an MAE.

The Court rejected this argument, finding that it need not consider whether Huntsman's decline was disproportionate to its peers unless it first determined that such decline was "materially adverse" to Huntsman's overall financial condition. In making this threshold determination, the Court, citing *In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14 (Del. Ch. 2001), noted that its focus is on "whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than in months." Moreover, because MAE provisions are essentially "backstops" to account for unknown events that threaten the target company's long-term earnings potential, the buyer bears a heavy burden when it seeks to terminate based on an MAE. Indeed, the Court found, despite Hexion's protestations, that absent clear language in the merger agreement to the contrary, the burden of proving the occurrence of an MAE rests on the party seeking to excuse performance regardless of whether the MAE is reflected as a closing condition or a representation. Thus, evidence of a significant decline in earnings by a target prior to closing is irrelevant for purposes of determining the existence of an MAE unless the poor earnings are "expected to persist significantly into the future."

The Court began its analysis of Huntsman's decline by noting that EBITDA, not earnings per share, is a better measure of the operational results of a business for purposes of determining the existence of an MAE in a cash deal. The Court also rejected Hexion's argument that the alleged MAE should be measured by the 32% decrease in Huntsman's projected 2008 EBITDA from $1.289 billion at the time of signing to $879 million on August 1, 2008, because the merger agreement explicitly disclaimed any representation or warranty by Huntsman with respect to such forecasts or projections. Instead, the Court compared Huntsman's EBITDA for each year and quarter to the equivalent period from the prior year. Measuring Huntsman's performance this way, the Court found that its 2007 EBITDA was only 3% below its 2006 EBITDA, and its estimated 2008 EBITDA (even using Hexion's forecast) would only be 11% below its 2007 EBITDA. This finding, coupled with an examination of Huntsman as a whole, led the Court to conclude that no MAE had occurred.

The Court next turned to the question of whether Hexion's actions amounted to a "knowing and intentional" breach of the merger agreement. Hexion argued that for its actions to be "knowing and intentional," it must be shown to have actual knowledge that its actions amounted to a breach of contract. The Court rejected this view, holding that a "knowing and intentional" breach is "a deliberate act, which act constitutes in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act." Using this standard, the Court examined Hexion's actions over the months leading up to trial, which included obtaining an insolvency opinion, publishing the opinion in a press release, and circulating the opinion among its lenders. The Court held that these actions amounted to knowing and intentional breaches of Hexion's covenants (i) to use its reasonable best efforts to take all actions necessary or advisable to secure financing for the transaction, (ii) not to take any action to impair, delay or prevent consummation of the financing, and (iii) to keep Huntsman informed about the status of the financing and to notify Huntsman if Hexion believed the financing was no longer available. The Court found that "Hexion's utter failure to make any attempt to confer with Huntsman when Hexion first became concerned with the potential issue of insolvency, both constitutes a failure to use reasonable best efforts to consummate the merger and shows a lack of good faith." Based on its finding that Hexion knowingly and intentionally breached the merger agreement, the Court held that the liquidated damages cap did not apply and Huntsman would be entitled to any damages proximately caused by Hexion's breach.

The Court declined to rule on Hexion's request for a declaration that the combined entity would be insolvent on the grounds that the issue was not ripe. Noting that there was no financing or insolvency "out" for Hexion, the Court explained that the combined entity's solvency had no bearing on Huntsman's obligation to close. Rather, the issue would not arise until closing, at which time Hexion's lenders would require a solvency letter or opinion as a condition to funding the transaction.

Finally, the Court ordered Hexion to specifically perform its obligations under the merger agreement, with one caveat. While the merger agreement provided the parties the right to seek specific performance of any obligations thereunder, Hexion's obligation to close was excepted from that provision. Therefore, Hexion could refuse to close, but if such refusal amounted to a breach of the merger agreement, Hexion would be liable to Huntsman for uncapped damages.

Court of Chancery Revisits The Line Between Gross Negligence and Bad Faith

Given the Court of Chancery's July 29 decision in *Ryan v. Lyondell Chemical Co.*, 2008 WL 2923427 (Del. Ch. Jul. 29, 2008),[1] and its subsequent decision denying a motion for interlocutory appeal in *Ryan v. Lyondell Chemical Co.,* 2008 WL 4174038 (Del. Ch. Aug. 29, 2008),[2] there is much interest in the evolving line between grossly negligent conduct (for which exculpation and indemnification are available) and bad faith conduct (for which exculpation and indemnification are not available) by directors of Delaware corporations. While the *Lyondell* decisions suggested that a lack of active board involvement in a company's sales process may state a claim for bad faith, two cases decided within the same week as the Court of Chancery's denial of the motion for interlocutory appeal seem to soften that view. In the first, *McPadden v. Sidhu*, 2008 WL 4017052 (Del. Ch. Aug. 29, 2008), the Court of Chancery held that the plaintiff failed to plead a violation of the duty of good faith where a board of directors allowed a conflicted executive to manage the sale of one of its divisions and subsequently failed to ensure that the process was thorough and complete. In the second case, *In re Lear Corp. Shareholder Litigation*, 2008 WL 4053221 (Del. Ch. Sept. 2, 2008), the Court of Chancery determined that the plaintiff failed to state a claim for bad faith where a board approved a $25 million naked no-vote termination fee in return for a $1.25 per share bump in merger consideration and emphasized that a court should exercise caution in considering whether actions of a majority-independent board of directors are in bad faith.

McPadden v. Sidhu

In June 2005, i2 Technologies, Inc. ("i2") sold its wholly owned subsidiary, Trade Services Corporation ("TSC"), to a group of TSC managers led by Anthony Dubreville ("Dubreville"), TSC's vice president, for $3 million. Two years later, Dubreville sold TSC for more than $25 million. The plaintiff sued i2's board of directors for breach of fiduciary duty in selling TSC to Dubreville and sued Dubreville, an officer but not a director, for breach of fiduciary duty and unjust enrichment. All defendants moved to dismiss the complaint for failure to state a claim and failure to make a demand under Court of Chancery Rule 23.1. The Court held that, because the plaintiff adequately pleaded gross negligence with respect to the sale process, demand was excused. However, because the directors' alleged conduct did not rise to the level of bad faith, i2's exculpatory charter provision authorized by Section 102(b)(7) required dismissal of the plaintiff's claim against the directors. Because a 102(b)(7) provision does not protect officers, Dubreville's motion to dismiss was denied.

i2 purchased TSC and a related company in 2001 for $100 million. In 2002, a TSC competitor expressed interest in purchasing TSC, but i2 was not interested in selling. By 2003,

---

[1] A complete discussion of the July 29 opinion can be found in our August 1, 2008 Delaware Corporate Law Update, available at http://www.rlf.com/richardsnews/corpUpdate080108.html.

[2] We note, however, that on September 15, 2008, the Delaware Supreme Court accepted interlocutory appeal. 2008 WL 4294938 (Del. Sept. 15, 2008).

the same competitor indicated it would pay up to $25 million for TSC. At the same time, Dubreville was allegedly driving down TSC's reported earnings by, among other things, incurring unnecessary expenses.

By December 2004, the i2 board decided to sell TSC, and tasked Dubreville, who was aware of the $25 million expression of interest and had discussed with the i2 board the possibility of a management buyout of TSC, with conducting the sale process. Sonenshine Partners ("Sonenshine"), i2's investment banker, prepared an offering memorandum in January 2005, which projected TSC's 2005 revenues to be $16 million. A month later, a revised offering memorandum was prepared with significantly reduced projections. In his solicitation of bids, Dubreville utilized the February offering memorandum and did not contact any of TSC's competitors, including the competitor that had expressed interest in purchasing TSC for up to $25 million.

Three bids for TSC were ultimately submitted, one of which was from Dubreville's group of investors. Dubreville's offer was for $2 million in cash and $1 million in software licensing agreements. Of the other two bids, one was for $1.8 million, and the other was $12 million for both TSC and a related subdivision which the board did not wish to sell. When i2's board of directors met in April 2005 to discuss the sale of TSC, Sonenshine informed the board that its valuation of TSC was $3-7 million using the February 2005 projections, and $6-10.8 million using the January projections. The board authorized management to negotiate with the Dubreville-led group. In June 2005, Sonenshine opined that Dubreville's proposed transaction was fair, and the board approved the sale. Two years later, Dubreville sold TSC for more than $25 million.

In addressing the plaintiff's failure to make demand pursuant to Rule 23.1, the Court determined that the plaintiff had pled particularized facts sufficient to excuse demand. First, the board tasked Dubreville—who the board knew was interested in purchasing TSC—with conducting TSC's sale. Second, the board did very little to oversee the sale process and did not attempt to rectify Dubreville's "half-hearted" efforts to solicit bids. In addition, the sale price was at the lowest end of the valuation range, even using the depressed February 2005 projections, and thus the board should have been "alerted to carefully consider whether Dubreville's offer was high enough." Because the Court found that the board's alleged conduct constituted gross negligence, demand was excused.

Although in most cases a complaint that survives a motion to dismiss under Rule 23.1 will also survive a motion to dismiss under Rule 12(b)(6), the Court found that the plaintiff failed to state a claim against the TSC directors. While the TSC directors' alleged conduct fit precisely within the definition of gross negligence (*i.e.*, reckless indifference or actions outside the bounds of reason), monetary liability for this violation of the directors' duty of care would be exculpated pursuant to the Section 102(b)(7) provision in i2's charter. The Court found that the plaintiff did not sufficiently allege conduct by the TSC directors that would amount to a non-exculpated breach of their duty of good faith (*i.e.*, a conscious disregard for their duties). Because the directors would be exculpated for a breach of the duty of care under i2's Section 102(b)(7) provision, the directors' motion to dismiss was granted.

Dubreville's motion to dismiss, on the other hand, was denied. The Court held that "[t]hough an officer owes to the corporation identical fiduciary duties of care and loyalty as owed by directors, an officer does not benefit from the protections of a Section 102(b)(7) exculpatory provision, which are only available to directors."

In re Lear Corp. Shareholder Litigation

Within days of the Court of Chancery's decision denying certification of an interlocutory appeal in *Ryan v. Lyondell*, and the decision granting (in part) the motion to dismiss in *McPadden v. Sidhu*, the Court of Chancery again addressed the fine line between pleading exculpated breach of due care claims and non-exculpated good faith violations in *In re Lear Corp. Shareholder Litigation*, 2008 WL 4053221 (Del. Ch. Sept. 2, 2008).

In a June 2007 decision in this case, the Court of Chancery had granted a limited preliminary injunction of the merger between Lear Corporation ("Lear") and entities controlled by Lear's largest stockholder, Carl Icahn (collectively, "Icahn").[3] After issuing the supplemental proxy statement required by the Court's order, Lear was having trouble securing votes in favor of the merger, as three major proxy-advisory services were recommending that Lear stockholders vote against the merger. As a result, a special committee of the Lear board began considering ways to garner additional support for the merger.

Lear's general counsel advised Lear directors that Lear might obtain additional support through a $1-2 per share increase in merger consideration. Accordingly, the chairman of the special committee and the CEO were authorized to work together to negotiate better terms from Icahn. While Icahn had stated publicly that he would not increase his offer, he eventually agreed to an additional $1.25 per share, conditioned upon a naked no-vote termination fee in the amount of $25 million—approximately 0.9% of the deal value.

On July 8, 2007, the Lear board approved the revised merger agreement. However, within days of its approval, Institutional Shareholder Services renewed its recommendation against the merger, and on July 16, Lear's stockholders rejected the revised merger agreement, triggering Lear's obligation to pay the no-vote termination fee.

Following the stockholders' rejection of the merger, the plaintiffs amended their complaint to add derivative claims against the Lear directors for breach of fiduciary duty in granting Icahn the naked no-vote termination fee, and against Icahn for unjust enrichment and for aiding and abetting the breach of fiduciary duties. The defendants moved to dismiss these new claims under Court of Chancery Rule 23.1 for failure to make a demand.

In order to survive the motion to dismiss, the plaintiffs were required to meet the heightened pleading standard set forth in *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984). Because eight members of Lear's eleven-member board were independent, the plaintiffs could not establish demand futility by satisfying *Aronson's* first prong. Instead, the plaintiffs had to allege

---

[3] A complete discussion of the Court of Chancery's prior opinion (*In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007)) can be found in our July 2007 Delaware Corporate Law Update, available at http://www.rlf.com/articles/richards_newsletters/corp_CL071007.pdf.

particularized facts creating a reasonable doubt that the transaction was the product of a valid exercise of business judgment. Because the Lear charter contained a Section 102(b)(7) provision, the plaintiffs had to rely on their allegations that Lear's directors had not acted in good faith. Specifically, the plaintiffs argued that the Lear directors had acted in bad faith by agreeing to the $25 million naked no-vote termination fee while purportedly knowing that Icahn's price bump would not be sufficient to encourage enough stockholders to vote in favor of the merger.

The Court rejected this argument for several reasons. First, the plaintiffs conceded in their complaint that there was uncertainty about the merger vote, so their contention that the Lear directors *knew* that the merger would be voted down was not persuasive. Second, the Court expressed reluctance to label as bad faith the actions of an independent board majority in considering a particular transaction. The Court explained that "a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties. Where, as here, the board employed a special committee that met frequently, hired reputable advisors, and met frequently itself, a *Caremark*-based liability theory is untenable." Because the board's decision was a valid exercise of business judgment, the Court dismissed the plaintiffs' claims.

Court of Chancery Finds that Preferred Equity Investment by Controlling Stockholder Fails Entire Fairness Review

In *In re Loral Space & Communications Inc. Consolidated Litigation*, 2008 WL 4293781 (Del. Ch. Sept. 19, 2008), the Court of Chancery held that a stockholder's imposition of a significant preferred equity financing transaction on the corporation was an interested transaction that was subject to review under the entire fairness standard. In its post-trial opinion, the Court found that the transaction was not a product of fair dealing, based on the composition and actions of the special committee that was formed to negotiate and approve the transaction, as well as the role of its financial advisors in the process, and that the terms of the transaction were unfairly advantageous to the stockholder. As a remedy, the Court took the unusual step of reforming the transaction so that the terms were fair to the corporation.

Loral Space and Communications Inc. ("Loral") emerged from bankruptcy in 2005 with a large institutional stockholder base comprised of former creditors, the largest of which was MHR Fund Management LLC ("MHR"), which owned 35.9% of Loral common stock. Of the eight Loral directors, three, including chairman Mark Rachesky ("Rachesky"), were MHR executives. In addition, Loral's vice chairman and chief executive officer, Michael Targoff ("Targoff"), and another director, John Harkey ("Harkey"), were affiliated with MHR as "Investment Advisors." Targoff was appointed as chief executive officer in March 2006, pursuant to an agreement with Rachesky. Shortly after his appointment, Targoff recognized that Loral was in need of additional capital to continue its recovery and believed that an investment by MHR would be the most efficient solution. Accordingly, Targoff proposed that MHR make an additional $300 million equity investment in Loral—an amount equal to over half of Loral's existing stock market capitalization. Rachesky quickly agreed to the idea of a large capital contribution by MHR. Without considering the possibility of other forms or sources of financing, the Loral board appointed a two-member special committee (the "Committee"), consisting of Harkey as chairman and a director unaffiliated with MHR, to evaluate and negotiate the proposed transaction. The negotiations between the Committee and MHR resulted in a Securities Purchase

Agreement (the "MHR Financing"). After learning of the MHR Financing, Loral stockholders sued, alleging that the MHR Financing was a conflicted transaction that was unfair to Loral.

In determining that the MHR Financing should be reviewed under the entire fairness standard, the Court pointed out that MHR had maintained publicly that it had control of Loral's board. Moreover, MHR directly controlled three of the eight directors on the Loral board and the two directors most responsible for negotiating the financing, Targoff and Harkey, could not be deemed to be independent of MHR. Thus, because five of the eight directors at the time the Securities Purchase Agreement with MHR was signed were affiliated with MHR, the financing was an interested transaction and the entire fairness standard presumptively applied. Notably, the Court also found that even though MHR owned less than a majority of the voting power of Loral, MHR was nonetheless a controlling stockholder because MHR possessed, as a practical matter, a combination of stock voting power and managerial authority enabling it to control the company.

The Court held that the defendants did not meet their burden under the entire fairness standard, finding that the MHR Financing was neither the product of fair dealing nor achieved at a fair price. With respect to fair dealing, the Court emphasized the inefficacy of the Committee, particularly in its composition and failure to consider all potential sources of financing. As described at length in the Court's opinion, the Committee was flawed in its composition based on Harkey's position as lead negotiator, its mandate to negotiate the proposed financing with MHR as opposed to finding the best deal reasonably available, and its futile negotiation approach. The Court found that MHR had dictated the timing, price and terms of the transaction with the company and that the Committee failed to use any leverage that it had or create additional leverage in negotiating the financing. The Court also criticized the competence of the investment banker hired by the Committee, noting the banker's lack of experience, failure to conduct any market test and reliance on the opinion of MHR's financial advisor that the lack of a market test was reasonable in this case. The Court concluded that "it is the sheer accumulation of examples of timorousness and inactivity that contributes to [the] conclusion that this Special Committee did not fulfill its intended function," and thus it was impossible to conclude that the Committee had acted as an effective negotiator.

In addressing fair price, the Court concluded that MHR received unfairly advantageous terms from Loral. The Securities Purchase Agreement gave MHR convertible preferred stock with a high dividend rate and low conversion rate compared to typical market terms. The Agreement also provided for dividends for five years on the preferred stock in paid-in-kind securities, a term inconsistent with market practices. Further, the "Change of Control Provisions" gave MHR extraordinary class voting rights with respect to almost any action by the Loral board, the right to put the convertible preferred stock to Loral in a change of control for a minimum value of $450 million, and the potential to acquire 63% of Loral's equity. These voting rights gave MHR veto power over virtually anything that Loral did and, as a result, anyone who wanted to take control of Loral would be obligated to hold a separate negotiation with MHR over whether to pay it a non-ratable share of the control transaction price. The Court concluded that the voting rights granted in connection with the preferred stock gave MHR an iron grip on Loral and the ability to extract a control premium for itself in any future change in control. The Court also noted that Loral paid to MHR a placement fee of $6.75 million, plus nearly $2 million to pay for MHR's financial advisor.

In determining the appropriate remedy and taking into account the unusual features of the MHR Financing, the Court held that the most equitable remedy would be to reform the Securities Purchase Agreement to convert the preferred stock that MHR received into non-voting common stock on terms fair to Loral. In fashioning its remedy, the Court sought to rectify the harm to Loral but to do so on a basis that was not punitive to MHR. As a result, post-reformation, MHR would hold 57% of the total equity of Loral, but remain at its prior level of voting power, 35.9%.

Delaware Supreme Court Remands "Anti-Destruction" Provision of Option Plan to Court of Chancery for Further Analysis

In *AT&T Corp. v. Lillis*, 953 A.2d 241 (Del. 2008), the Delaware Supreme Court disagreed with the Court of Chancery's analysis of an ambiguous "anti-destruction" provision of a 1994 stock option plan (the "1994 Plan") and remanded the matter to the Court of Chancery for further consideration on the issue of whether the option holders were entitled to receive additional consideration reflecting the time value of their options in a cash-out merger.

On July 20, 2007, the Court of Chancery issued an opinion holding that certain stock options granted to former officers and directors of MediaOne Group, Inc. (the "MediaOne plaintiffs") were improperly adjusted in connection with a 2004 cash-out merger. Specifically, the cash consideration received by the MediaOne plaintiffs for their options was the merger price minus the strike price—the "intrinsic value"—instead of the intrinsic value *plus* the options' time value, which constitutes the options' potential for future appreciation. This finding was based in part on the Court's review of extrinsic evidence to resolve ambiguity in the "anti-destruction" provision of the 1994 Plan, which provided that, in the event of certain transactions, the option holders' "economic position" would be no worse than immediately prior to the transaction. [4]

On appeal, the Delaware Supreme Court agreed that the phrase "economic position" in the 1994 Plan was ambiguous, but, after its own review of the extrinsic evidence presented by the parties, disagreed with the Court of Chancery's analysis of the parties' prior course of conduct.

The Supreme Court noted that the Court of Chancery did not mention the fact that each of the previous transactions involving options granted pursuant to the 1994 Plan—the 1999 merger of MediaOne with AT&T Corp. ("AT&T") and the 2001 spin-off of AT&T Wireless Services, Inc. ("Wireless") by AT&T—were stock-for-stock transactions. In a stock-for-stock transaction, the "economic position" of stock options will invariably incorporate the expected time value of the new options. By contrast, the 2004 merger between Wireless and Cingular Wireless LLC ("Cingular") was a cash-out merger. In a cash-out merger, the option holder receives cash representing only the intrinsic value, and not the lost time value, of their options. Therefore, the treatment of options in the previous stock-for-stock transactions was not necessarily probative of the parties' intent in the cash-out merger with Cingular. The Supreme Court remanded the matter to the Court of Chancery with the instruction to address this distinction in its evaluation of the extrinsic evidence to divine the intent behind the "anti-destruction" provision.

---

[4] A complete discussion of the Court of Chancery's prior opinion (*Lillis v. AT&T Corp.*, 2007 WL 2110587 (Del. Ch. July 20, 2007)) can be found in our October 2007 Delaware Corporate Law Update, available at http://www.rlf.com/articles/richards_newsletters/corpUpdate100407.htm.

In its opinion on remand in *Lillis v. AT&T Corp.*, 2008 WL 2811153 (Del. Ch. July 21, 2008), the Court of Chancery concluded that it had not given due weight in its prior opinion to the distinction between stock-for-stock versus cash mergers, and therefore its previous reliance on stock-for-stock transactions that adjusted the options to preserve full economic value should not be given significant weight in a cash-out merger scenario. The Court also reiterated its position in the trial opinion that the fact that stock options were a large portion of the MediaOne plaintiffs' compensation was of little significance to its determination.

Based on the Supreme Court's instructions and the general rule that "anti-destruction" provisions go hand-in-hand with receiving intrinsic value—not full economic value—for stock options in a cash merger, the Court of Chancery concluded on remand that the MediaOne plaintiffs failed to demonstrate that the "anti-destruction" provision required an adjustment to preserve both the intrinsic value and the time value of their options.