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DELAWARE CORPORATE LAW BULLETIN

"THERE MOST CERTAINLY WAS A 'TOMORROW' ": CHANCERY COURT FINDS *REVLON* REVIEW NOT TRIGGERED WHEN ACQUIRER STOCK CONSTITUTED 58% OF MERGER CONSIDERATION

Opinion also indicates that technical noncompliance with DGCL § 203 will not trigger supermajority voting requirements for a negotiated transaction not subject to "abusive takeover tactics"

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INTRODUCTION

In *Flannery v. Genomic Health, Inc.*, No. 2020-0492-JRS, 2021 WL 3615540 (Del. Ch. Aug. 16, 2021) ("*Flannery*"), Vice Chancellor Joseph R. Slights III of the Delaware Court of Chancery ("*Chancery Court*") granted defendant directors' motions to dismiss claims alleging (i) violation of §203 of the Delaware General Corporate Law ("*DGCL § 203*") in connection with a corporate merger, and (ii) breach of fiduciary duty under principles articulated by the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) ("*Revlon*"). *Flannery* offers important clarifications of both the requirements of DGCL § 203 and questions left unanswered by *Revlon* and its progeny.

I. LEGAL BACKGROUND

DGCL § 203. DGCL § 203, titled "Business combinations with interested stockholders," offers an additional takeover defense to boards of directors of corporations that have not elected to opt-out of the statute's protections. Essentially, DGCL § 203 was designed "to strike a balance between the benefits of an unfettered market for corporate shares and the well-documented and judicially recognized need to limit abusive takeover tactics."

In operation, DGCL § 203 prohibits an "interested stockholder" from engaging in a variety of business combination transactions for three years after the stockholder achieves that status. However, if (i) the board of directors gives prior approval to the transaction which results in the stockholder becoming an interested stockholder, (ii) the interested stockholder owns at least 85% of the outstanding voting stock upon consummation of the transaction which results in the stockholder becoming an interested stockholder, *or* (iii) the *business*

combination transaction is approved by both (x) the board of directors and (y) *a* two-thirds vote of the other stockholders (a "*Two-Thirds Vote*"), then the three-year ban on business combination transactions is inapplicable. An "interested stockholder" is "one who 'is the *owner* of 15% or more of the outstanding voting stock of the corporation,' " and an "owner" includes a person who "[h]as any agreement, arrangement or understanding for the purpose of acquiring, holding, voting . . . or disposing of such stock. . . ."

When negotiating a corporate buyout, dealmakers and their counsel generally take care to structure and time the discussions in a manner that does not cause the acquirer to become an "interested stockholder" *before* the target board approves the transaction. Vice Chancellor Slights' analysis of DGCL § 203 in *Flannery* provides helpful insight into these structural and timing considerations.

Revlon. Under *Revlon*, "in the change-of-control context, the duty of loyalty requires 'the maximization of the company's value at a sale for the stockholders' benefit.' " The *Revlon* court also designated "enhanced scrutiny" as the applicable judicial standard of review for claims questioning corporate fiduciary adherence to their so-called "*Revlon* duties." Two essential questions in the *Revlon* context are (i) at what point, in the pursuit of a change of control transaction, do the actions of the target company board of directors become subject to enhanced scrutiny; and (ii) is *Revlon* applicable to a transaction where the merger consideration is a mixture of cash and acquiring company stock?

In *Flannery*, addressing the first question, Vice Chancellor Slights found that preliminary contacts with a potential acquirer who failed to make a bid but reappeared "out of the blue" two years later did not constitute "an 'active bidding process' " implicating *Revlon*. With respect to the second question, the Vice Chancellor observed that a mixed cash and stock transaction in which target stockholders retained 58% of their stock position, and therefore the ability to secure a premium from a future takeover, did not present the traditional *Revlon* scenario in which there was "no tomorrow" for target stockholders.

II. FACTUAL BACKGROUND

A. BBE Becomes the Company's Largest Stockholder

Genomic Health, Inc. (the "*Company*") is "a global provider of genomic-based diagnostics tests." In the mid-2000s, investment entities under the umbrella of Baker Brothers Entities (collectively "*BBE*"), founded by Julian and Felix Baker (the "*Baker Brothers*"), began to

accumulate Company stock. Between September 2006 and June 2013, BBE increased its ownership stake from 6.1% to a high-water mark of 45.8%. Early in this period, the Baker Brothers joined the Company's board of directors (the "*Board*"). Most of the other Board members either were nominated by, or had long-standing business relationships with, the Baker Brothers.

B. Company Unsuccessfully Explores Sale

Following a four-year decline in the Company's stock trading price, in October 2017, the Board determined "it was appropriate to consider strategic alternatives for the Company, including a sale." To that end, Goldman Sachs & Co., LLC, the Company's financial advisor, contacted twenty-seven potential bidders, convincing sixteen of them to enter into confidentiality agreements. One of these potential bidders was Exact Sciences Corporation ("*Exact*"), which specializes in "molecular diagnostics." While two of the potential bidders submitted indications of interest, neither proceeded beyond that preliminary stage and the process ended.

C. Exact Re-enters the Picture

Shortly after the sales process fizzled out, the Company began reporting promising results, triggering a stock price rise continuing throughout 2018. As the stock price climbed, BBE gradually sold off a large portion of its holdings, leaving it with a 25.9% position by April 2019. Then, on June 11, Exact's CEO contacted the Company's CEO "out of the blue" to discuss a potential combination. Two days later, Exact submitted an offer of $64 a share, comprised of 20% cash and 80% Exact stock. After the Board determined that Exact's stock was trading at historically high levels and more cash would be needed, Exact raised its offer to $68 a share. Then, after the Company CEO (without Board authorization) advised Exact's financial advisors of the Company's "double digit growth projections over the next 5 years," Exact raised again, this time to $70 a share, comprised of 30% cash and 70% stock. After a series of counteroffers by the Board and responses from Exact, Exact offered $72 per share, comprised of $27.50 in cash and $44.50 in stock (the "*Final Offer*").

As negotiations proceeded, on July 23, the Company was added to the S&P SmallCap 600, sparking an immediate 15% jump in the Company's stock price. The Board recognized this increase at a July 26 meeting, "but chose not to capitalize on the news" by making another counteroffer to Exact.

In the meantime, Exact's counsel "demanded that [BBE] enter into a voting agreement and vote their stock in favor of a future transaction." These talks stalled on July 26 when BBE "refused to agree to trading restrictions" as part of the voting agreement. However, BBE's counsel informed Exact that BBE "intended to vote in favor of the transaction."

When various media outlets began reporting a potential transaction between the two companies, on July 27, Exact urged the Board to move swiftly to approve the transaction. The next day, the Board accepted the Final Offer, which reflected a 5% premium over the then-current stock price despite the recent rise in the stock price, and approved the transaction. The parties structured the transaction as a merger in which the Company would survive as a wholly-owned subsidiary of Exact (the "*Merger*"). Immediately thereafter, BBE entered into a voting agreement with Exact requiring BBE to vote in favor of the Merger (the "*Voting Agreement*"). The Merger was approved "by 79.40% of [Company] stockholders unaffiliated with [BBE]" on November 7.

D. Litigation Ensues

Later that month, a former Company stockholder ("*Plaintiff*") filed suit in Chancery Court alleging that, among other things, (i) Exact violated DGCL § 203 by becoming an "interested stockholder" before the Board approved either its status as such or the Merger, and (ii) the members of the Board breached their fiduciary duties by approving a transaction whose sales process was "riddled with defects" that produced a "fundamentally unfair price." In *Flannery*, Vice Chancellor Slights granted defendants' motions to dismiss both these claims.

III. VICE CHANCELLOR SLIGHTS' ANALYSIS

A. DGCL § 203

Plaintiff asserted that Exact violated DGCL § 203 because (i) without prior Board approval, it became an "interested stockholder" by securing BBE's voting commitment for its "greater than 15% stake" in the Company under the Voting Agreement, and (ii) thereafter, completed a "business combination"—the Merger —without obtaining a Two-Thirds Vote. Vice Chancellor Slights rejected this claim on two separate grounds.

1. Exact Not An "Interested Stockholder" Before Board Approved

Merger

As noted above, one may become an "owner" of stock for purposes of DGCL § 203 by entering into an "agreement, arrangement or understanding for the purpose of acquiring, holding, voting . . . or disposing of such stock. . . ." Vice Chancellor Slights explained that the "meeting of the minds" required for such an "agreement" was not evident before the Board approved the Merger on July 28. In fact, BBE's rejection of Exact's proposed voting agreement on July 26, due to the inclusion of transfer restrictions, belied a "meeting of the minds" at that point. That BBE simultaneously "expressed their then-present, non-binding intent eventually to support the Merger" was insufficient, in the Vice Chancellor's view, to alter his conclusion. Absent an explicit agreement between the parties before Board approval of the Merger, "Exact cannot conceivably be classified as an Interested Stockholder and thus cannot have violated Section 203." Moreover, the signing of the Voting Agreement "immediately *after*" Board approval "evidences nothing more than the commonplace scenario where a large stockholder agrees to vote its shares in favor of a transaction approved and authorized by the board of the target company."

2. Board Implicitly Approved Voting Agreement Before Approval of Merger

Even if Exact became an "interested stockholder" when the Voting Agreement was signed, Vice Chancellor Slights observed, Plaintiff failed to argue that the Board either (i) was unaware of the negotiations between Exact and BBE or (ii) disapproved of these negotiations. In fact, Exact's counsel sent a draft Merger agreement to the Company on July 16 that "expressly contemplated Exact would enter into certain voting agreements with [Company] stockholders." The Company did not challenge this point. Thus, the Vice Chancellor found it reasonable to infer that the Board was well aware of the "unremarkable proposition" that Exact, while negotiating the Merger, would seek voting commitments from the Company's largest stockholder.

Moreover, the signing of the Voting Agreement immediately after Board approval of the Merger "further suggests this was not an interested stockholder acting to take over the Company without the Board's consent, which . . . is the precise problem Section 203 was designed to solve." Quite simply, because Exact was not engaged in "abusive takeover tactics," and the Board was actively involved in the negotiations, the Vice Chancellor was "hesitant to strain the statute's

language to cover situations that do not threaten the interests the statute was designed to protect . . . ."

B. Standard of Review for Fiduciary Duty Claims

Having dispensed with Plaintiff's DGCL § 203 claim, Vice Chancellor Slights turned to her breach of fiduciary duty claims. This required the Vice Chancellor to tackle the "gating question . . . under what standard of review will the court adjudicate the claim." Although Plaintiff "pulled out all stops to implicate either entire fairness review or *Revlon* enhanced scrutiny in order to survive dismissal," the Vice Chancellor opted to apply the deferential business judgment presumption.

1. Entire Fairness Inapplicable

In seeking application of entire fairness, the most intrusive standard of judicial review, Plaintiff argued "the Merger was the product of the undue influence of a conflicted controlling stockholder [who] . . . competed with the minority through the extraction of a nonratable benefit, namely increased liquidity." According to the Vice Chancellor, "[n]either argument holds weight under our law."

First, the Vice Chancellor found that Plaintiff insufficiently pled that BBE controlled either the Company or the Merger process. In this connection, he noted that BBE held "a mere 25% voting interest," controlled "only two of the eight Board seats," and tended not to "meddle in the day-to-day operations of the Company." The Vice Chancellor also found no support for Plaintiff's inference that the directors were "beholden" to BBE or their discretion was "sterilized" to the point that BBE exercised "actual control" over the transaction.

Second, even if Plaintiff had demonstrated that BBE controlled the Company or the Merger process, she fell flat in asserting that BBE extracted a "unique benefit" by seeking liquidity through an "exit" of their investment in the Company. Precedent instructs that "'Delaware courts have been reluctant to find that a liquidity-based conflict rises to the level of a disabling conflict of interest when a large blockholder receives pro rata consideration." Further, "a mere desire to sell cannot create a conflict given that controlling stockholders 'usually have the largest financial stake in the transaction and thus have a natural incentive to obtain the best price for their shares.' " The Vice Chancellor saw nothing in Plaintiff's complaint sufficient to overcome this presumption. Although "pleading a 'fire sale' is not necessary," a plaintiff must at least plead " 'facts that support a reasonable inference

of a divergent interest' with respect to liquidity." Neither BBE's desire to support the Merger, nor its recent "history of stock sales," were in any "way indicative of a liquidity crisis or a desire to extract consideration from the market at the expense of other stockholders."

2. Enhanced Scrutiny Inapplicable

Vice Chancellor found enhanced scrutiny inapplicable on two separate grounds: *first*, citing Delaware precedent, Vice Chancellor Slights explained that enhanced scrutiny review under *Revlon* is triggered in one of three ways:

> (1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company[ ]; (2) where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or (3) when approval of a transaction results in a sale or change of control[.]

The Vice Chancellor found "none of these triggers confronted the Board with respect to the Merger." Relying on the first trigger, Plaintiff asserted an "active bidding process" commenced in October 2017 when the Board sought initial indications of interest and continued through Board approval of the Merger some eighteen months later. The Vice Chancellor saw things differently, finding that "[w]hile Exact may have sought to get a glimpse behind the curtain in 2017, . . . the only reasonable inference . . . is that Exact faded away in the mist along with all the other potential suitors in 2017." Thereafter, "[a]ll remained quiet on the transaction front" until Exact contacted the Company "*out of the blue*" (emphasis added) in June 2019, followed by roughly six weeks of "significant back-and-forth" negotiations between Exact and the Company. According to the Vice Chancellor, "[t]his cannot conceivably be characterized as an 'active bidding process.' "

Second, and "[e]ven more importantly," the Vice Chancellor found "no well-pled allegations that the Merger resulted in a change in control." Before the Merger, the Company had "no controlling stockholder" and, as Plaintiff pled nothing about Exact's resulting capital structure, her complaint "offer[ed] no basis to infer that the Merger changed this dynamic." While *Revlon* applies to all-cash transactions "because there is no tomorrow for the corporation's present stockholders," the mix of consideration in the Merger—58% stock and 42% cash—permitted Company stockholders to "stay[ ] in a large, fluid, changeable and changing public market," thereby retaining "the possibility of 'obtain[ing] a future control premium.' " As such, "it cannot be said that [the Company] abandoned its long-term strategy, triggering a duty to maximize short-term gain" under *Revlon*. The Vice

Chancellor also noted that because "the proper focus is the mix of pre-merger consideration rather than the target stockholder[s'] post-merger stake" in the acquiring company, the fact that former Company stockholders "maintain[ed] only a 10.4% equity stake in the post-merger Exact" was irrelevant to his analysis.

It should be noted that the Delaware Supreme Court has not yet definitively ruled on the parameters for applying *Revlon* in a mixed cash and stock transaction. As Vice Chancellor Slights cautioned, "since 'the Supreme Court has not yet established a bright line rule for what percentage of merger consideration could be cash without triggering *Revlon*,' the court's determination that *Revlon* is inapplicable here is not 'free from doubt.' "

C. Post-Closing Damages

Finally, Vice Chancellor Slights noted that even if *Revlon* applied, to avoid dismissal of her post-closing damages claim, Plaintiff was required to plead a nonexculpated claim of breach of fiduciary duty based on failure by the Board "to secure the highest attainable value as a result of their own bad faith or disloyal conduct." Mindful that the Chancery Court "has vividly explained [that] the complaint that well pleads bad faith 'is a [rare bird],' " the Vice Chancellor noted that Plaintiff's "[c]omplaint does not approach 'rare bird' status."

Plaintiff argued the Company's sales process was tainted by bad faith. In stark contrast, the Vice Chancellor recognized in Plaintiff's complaint evidence of a "robust process" with an "extensive [albeit unsuccessful] market check in 2017," followed in 2019 by an "unsolicited acquisition proposal" that sparked "a fulsome negotiation leading to a fully arms-length transaction" providing a 5% premium for Company stockholders. Further, the Merger was approved by a "disinterested Board, with guidance from disinterested financial and legal advisors, and then an overwhelming majority of disinterested stockholders." Therefore, the Vice Chancellor concluded, Plaintiff "does not well plead a tainted negotiation process that resulted in a demonstrably bad deal on its face."

CONCLUSION

Vice Chancellor Slights's opinion in *Flannery* provides several practical insights for M&A transaction planners:

First, the Vice Chancellor's focus on the underlying purpose of DGCL § 203 to combat "abusive takeover tactics" should be of relief to potential acquirers seeking to lock up the vote of significant

stockholders while negotiating the terms of an acquisition. In the absence of such tactics, it would seem of no benefit to anyone to subject the negotiated transaction to a supermajority stockholder vote due to technical noncompliance with the statute.

Second, in concluding the Board's unsuccessful effort to find a buyer was not part of an "active bidding process," the Vice Chancellor provided needed clarification on an issue key to application of the enhanced scrutiny. While it is difficult to forecast, in the midst of a sales process, whether a court will exercise 20/20 hindsight to determine if and when enhanced scrutiny was triggered, *Flannery* offers boards of directors a measure of certainty that preliminary sales efforts that do not result in a completed transaction likely will not be subjected to judicial second-guessing.

Third, while nothing is certain until the Delaware Supreme Court weighs in, *Flannery* provides another helpful declaration by the Chancery Court that *Revlon* review is not implicated by a mixed cash and stock transaction where the stock portion represents a majority of the aggregate consideration.