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Robert S. Reder

Sasha A. Gombar

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DELAWARE CORPORATE LAW BULLETIN

Chancery Court Rejects Target Company Claim That Termination Fee Was Jilted Merger Partner's Exclusive Remedy

*Robert S. Reder**

*Alexandra Sasha Gombar***

**Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank LLP in New York City since his retirement as a partner in April 2011.*

***Vanderbilt University Law School, J.D. Candidate, May 2021.*

In rejecting target company's motion to dismiss, court determines that original merger partner adequately pled breach of merger agreement's non-solicitation provision

INTRODUCTION

It certainly is interesting, and sometimes newsworthy, when a Delaware court has an opportunity to analyze familiar provisions of a merger agreement governing the purchase of a publicly traded corporation ("*public merger agreement*"). More often than not, interpretative disputes over these provisions are settled by the parties rather than taken to court. Thus, on those rare occasions when Delaware courts do have a chance to make interpretative rulings, corporate dealmakers, as well as M&A advisers and practitioners, should take notice.

For instance, in *Dolan v. Altice USA, Inc.*, C.A. No. 2018-0651-JRS, 2019 WL 2711280 (Del. Ch. June 27, 2019) ("*Dolan*"), the Delaware Court of Chancery ("*Chancery Court*") denied an acquiring company's motion to dismiss an action brought by target company stockholders to enforce a post-merger covenant. The public merger agreement, by its terms, seemed to deny the former stockholders any right to bring such a claim. It also seemed to indicate the covenant did not survive effectiveness of the merger. Nevertheless, and notwithstanding the acquiring company's characterization of the covenant as "aspirational, albeit unenforceable," the Chancery Court found the relevant provisions of the public merger agreement—perhaps "boilerplate" to some—to be ambiguous, necessitating a review of extrinsic evidence to discern the parties' actual intentions. (*See* Robert S. Reder & Faisal Q. Haider, *Chancery Court Refuses to Dismiss Action to Enforce Post-Merger Covenant Due to Ambiguities in Merger Agreement,* 72 VAND. L. REV. EN BANC 27 (2020).)

Recently, in *Genuine Parts Co. v. Essendant Inc.*, C.A. No. 2018-0730-JRS, 2019 WL 4257160 (Del. Ch. Sept. 9, 2019) ("*Genuine Parts*"), the Chancery Court had another opportunity to analyze standard public merger agreement provisions. Vice Chancellor Joseph R. Slights III was asked to consider whether receipt of a termination fee (sometimes called a "break-up fee") was a jilted acquiring company's "sole and exclusive remedy" when the target company exercised its "fiduciary out" to terminate the agreement and accept a "superior proposal." Although the agreement expressly stated the termination fee was the "sole and exclusive remedy," it also required the target company to follow a series of steps before exercising the fiduciary out. Because the acquiring company offered "well-pled" allegations that the target company materially breached the "non-solicitation" provisions of the merger agreement in securing the superior proposal, the Vice Chancellor refused to dismiss the acquiring company's action for breach of contract.

I. FACTUAL BACKGROUND

A. *Two Competitors Agree to Merge*

On April 12, 2018, Genuine Parts Company ("*GPC*") and Essendant Inc. ("*Essendant*") entered into a merger agreement ("*Agreement*") calling for Essendant to merge ("*Merger*") with GPC's "component," S.P. Richards Co. The Merger intended to unite two "wholesale distributor[s] of workplace supplies and equipment" who were "[f]acing increasing competition in the office supply market." As a result of the Merger, GPC stockholders would own 51% of Essendant's common stock, and Essendant stockholders would own the rest.

The Agreement included "several protections for GPC" typical of public merger agreements. Under Section 7.03(a) (the "*Non-Solicitation Provision*"), "Essendant agreed not to solicit, initiate, or knowingly encourage . . . or take any other action to knowingly facilitate, any inquiries or the making of any proposal or offer . . . with respect to any Competing [Essendant] Transaction." Essendant also agreed in this section "to terminate any discussions concerning competing transactions that had started prior to the execution of the Agreement."

Although Essendant was precluded from soliciting competing offers post-signing, Section 7.03(c) (the "*Window Shop*") authorized Essendant to provide information and enter into discussions with anyone who "made a written, bona fide proposal or offer with respect to a Competing [Essendant] Transaction that did not arise or result from any material breach of" the Non-Solicitation Provision. Notably, the Window Shop applied only to post-signing, unsolicited proposals deemed by Essendant's board of directors (the "*Board*"), "in its good faith judgment," to be "reasonably likely to lead to [ ] a Superior Proposal[.]" A "Superior Proposal" was one the Board:

> determine[d], in its good faith judgment, after consulting with a financial advisor of internationally recognized reputation and external legal counsel . . . to be (a) more favorable from a financial point of view, to the stockholders of [Essendant] than the Merger and (b) reasonably expected to be consummated.

Section 9.01(g) (the "*Fiduciary Out*") authorized Essendant "to terminate the Agreement 'to enter into a definitive agreement with respect to a Superior Proposal.' " Exercise of the Fiduciary Out was subject to two conditions: *first*, compliance with Section 7.03(d)(ii), requiring that exercise of the Fiduciary Out "not arise or result from any material breach" of the Non-Solicitation Provision, and *second*, payment of $12 million under Section 9.03(a)(ii) (the "*Termination Fee*"). Section 9.03(e) stated payment of the Termination Fee was the "sole and exclusive remedy of GPC" if Essendant exercised the Fiduciary Out, but only if the Termination Fee was paid "in accordance with this Section 9.03."

Section 9.02 dictated there would be no liability on the part of either party for any " 'valid termination' of the Agreement" other than in the case of fraud or any "breach of, or failure to perform any of the covenants or other agreements contained in this Agreement . . . with actual knowledge that such . . . act or failure to act would, or would reasonably be expected to, result in or constitute a breach of or failure of performance under the Agreement" ("*Willful Breach*").

B. Sycamore Presents a Competing Proposal

Three days before the Agreement was signed, private equity firm Sycamore Partners ("*Sycamore*"), whose portfolio includes office supply giant Staples, "expressed interest in acquiring Essendant." The Board signed the Agreement without mentioning Sycamore's overture to GPC. Five days after signing, Sycamore "formally offered" to acquire Essendant for $11.50 per share ("*First Offer*"), representing "a premium to GPC's offer." The Board rejected the First Offer because it "was unlikely to lead to a Superior Proposal."

However, according to GPC, Essendant at the same time "conveyed to Sycamore that it would be open to receiving a revised offer." Then, on April 29th, Sycamore submitted a "renewed" proposal ("*Renewed Offer*") still valuing Essendant at $11.50 per share, but this time "indicat[ing] it might make a higher bid upon receiving non-public information." On the basis of this addition, the Board determined the Renewed Offer "was reasonably likely to lead to a Superior Proposal." Essendant finally advised GPC of Sycamore's offer and this determination on May 4th.

On May 7th, GPC disputed that the Renewed Offer qualified as a Superior Proposal, citing both a preliminary discounted cash flow analysis and anticipated objections from antitrust regulators. Although GPC warned Essendant that any further discussions with Sycamore would violate the Non-Solicitation Provision, it also offered to pay $4 more per share "in the form of a contingent value right."

Before Essendant replied to GPC's revised offer, Sycamore publicly disclosed it had acquired beneficial ownership of 11.16% of Essendant's shares. Then, on June 1st, the Board rejected GPC's revised offer. "After several additional months of negotiations," on September 10th, the Board accepted an enhanced $12.80 per share offer from Sycamore. Per the Fiduciary Out, on September 14th, Essendant terminated the Agreement and paid GPC, "and GPC accepted," the

Termination Fee. Sycamore thereafter completed its purchase of Essendant.

C. GPC Sues for Breach of Contract

Not content with the Termination Fee, on October 10th, GPC sued Essendant in Chancery Court to recover damages caused by Essendant's alleged breach of the Agreement. Specifically, GPC claimed Essendant breached the Agreement by:

- Rejecting the First Offer, then encouraging Sycamore to rebid by indicating "it would be open to receiving a revised offer," and continuing to engage in discussions with Sycamore thereafter;

- Failing to require Sycamore to enter into an "Acceptable Confidentiality Agreement" with Essendant as required by the Window Shop;

- Terminating the Agreement under the Fiduciary Out without obtaining a Superior Proposal; and

- Failing to use "reasonable best efforts" to complete the Merger as required by the Agreement.

Essendant moved to dismiss, arguing the Termination Fee was GPC's "sole remedy" under the Agreement, "whether adequate or not." Essendant also argued that by accepting the Termination Fee, GPC effectively waived its right to claim Essendant breached the Agreement. GPC countered that the Termination Fee "was neither an exclusive remedy," nor even an "adequate remedy," because the Sycamore transaction came about due to GPC's breach of the Non-Solicitation Provision.

II. VICE CHANCELLOR SLIGHTS'S ANALYSIS

Vice Chancellor Slights denied Essendant's motion to dismiss, concluding "the Agreement does not clearly and unambiguously provide that GPC's remedy is limited to" the Termination Fee "where, as here, GPC has well-pled that Essendant breached" the Non-Solicitation Provision. He then conducted "a whistle-stop tour through several of [the] interconnected provisions" of the Agreement.

A. Termination Fee Not Exclusive Remedy

According to Essendant, the "clear and unambiguous terms" of Section 9.03(e) provided that, upon Essendant's exercise of the Fiduciary Out, "the Termination Fee shall be the sole and exclusive remedy of GPC." Parsing the operative language of the Agreement in greater detail, GPC pointed out that Section 9.03(e) conditioned exclusivity of the Termination Fee on Essendant following a "contractually-sequenced path."

The Vice Chancellor began his analysis of this "contractually-sequenced path" by explaining that the Termination Fee was payable pursuant to Section 9.03(a)(ii) in connection with "termination of the Agreement 'pursuant to' Section 9.01(g)"; that is, via Essendant's exercise of the Fiduciary Out. Section 9.01(g) authorized Essendant to exercise the Fiduciary Out "to enter into a definitive agreement with respect to a Superior Proposal to the extent permitted by, and subject to the applicable terms and conditions of, Section 7.03(d)(ii)." Section 7.03(d)(ii), in turn, authorized termination under Section 9.01(g) in response to an offer "that: (i) did not arise from a material breach of [the Non-Solicitation Provision], and (ii) the Essendant board properly determined to constitute a Superior Proposal."

On this basis, the Vice Chancellor concluded "there is room in Section 9.03(e) for GPC to argue that the exclusive remedy provision does not apply because: (i) there was no Superior Proposal; and, if there was one, (ii) it resulted from a material breach of the Agreement." In other words, the exclusivity of the Termination Fee as a remedy depended on whether Essendant complied with the Non-Solicitation Provision and therefore was, under the circumstances, entitled to exercise the Fiduciary Out.

B. Acceptance of Termination Fee Not a Waiver of Other Remedies

Next, Essendant argued GPC's acceptance of the Termination Fee precluded it from contesting the validity of Essendant's exercise of the Fiduciary Out. Vice Chancellor Slights disagreed, explaining "GPC's acceptance of the fee to which it is unquestionably entitled is nothing more than that—acceptance of a payment owed without waiver of its claim that more is owed."

Citing Chancery Court precedent, the Vice Chancellor found "no basis to conclude that GPC's acceptance of the Termination Fee precludes it from pursuing breach of contract claims as a matter of law." The Vice Chancellor noted that Essendant lacked citation to a provision of the Agreement suggesting GPC's acceptance of the Termination Fee precluded it from pursuing a breach of contract claim.

C. GPC Adequately Pled Breach of Contract

After rejecting Essendant's exclusive remedy and waiver defenses, Vice Chancellor Slights turned to the question of whether GPC adequately pled a claim for material breach of contract. As a preliminary matter, the Vice Chancellor concluded violation of the Non-Solicitation Provision by Essendant could constitute a "material breach" of the Agreement. A "material breach," the Vice Chancellor explained, "is a failure to do something that is so fundamental to a contract that the failure to perform that obligation defeats the essential purpose of the contract or makes it impossible for the other party to perform." The Vice Chancellor found it reasonable to conclude that one of the fundamental purposes of the Agreement, at least for GPC, "was lawfully to secure GPC's exclusive ability to merge with Essendant." He viewed GPC's inclusion of the Non-Solicitation Provision in the Agreement as key to achieving this goal.

The Vice Chancellor explained that the Non-Solicitation Provision, "common in merger agreements," does not necessarily conflict with a Delaware board's fiduciary duty "to secure the best value reasonably available to stockholders." Indeed, Essendant did not attack the Non-Solicitation Provision as "overly restrictive." More to the point, by allowing the Board to discuss competing transactions post-signing, so long as those discussions did not materially breach the Non-Solicitation Provision, the Window Shop actually permitted the Board to satisfy its duties to stockholders.

Next, the Vice Chancellor explained, while none of the allegations in GPC's complaint "standing alone" stated a claim of material breach, when taken together, the allegations supported a "reasonably conceivable claim" Essendant engaged in "a wrongful and furtive pattern of contacts and cooperation that breached and undermined the entire Merger Agreement." *First*, because Sycamore approached Essendant before the Agreement was signed, Sycamore was not the kind of post-signing "pop-up bidder" contemplated by the Window Shop. *Second*, Essendant was required by the Non-Solicitation Provision to terminate all discussions it was having with other bidders upon signing the Agreement. *Third*, when it declined the First Offer, the Board allegedly signaled to Sycamore its receptivity to an improved offer. *Fourth*, the Board accepted the Second Offer "shortly after" receipt, even though the Second Offer was nearly identical to the First Offer. In fact, the only difference between the two, according to GPC, was Sycamore's intimation that it might increase the Second Offer if allowed to review Essendant's "non-public information." And, *fifth*, GPC alleged that Essendant permitted Sycamore to review non-public information without entering into an "Acceptable Confidentiality Agreement" as required by the Non-Solicitation Provision. Taken together, these allegations provided a "reasonable inference" the Board "shared its preferences or inclinations with Sycamore, thereby encouraging it to resubmit its offer with a slight alteration so the [B]oard could 'properly' begin competing negotiations."

Essendant sought to counter GPC's allegations by claiming "a rejection of an offer always implies that, if a better offer follows, then it will be considered." In essence, Essendant argued that even if the Board explicitly told Sycamore, in response to the First Offer, "that a better offer would be considered, no material breach occurred because the [B]oard provided no new information to the mix." Essendant offered as an example of "new information" if the Board "informed Sycamore that a cash deal was preferred to a stock deal." The Vice Chancellor did not find this reasoning persuasive.

CONCLUSION

Vice Chancellor Slights's opinion in *Genuine Parts* shows the perils a party may face when it fails to abide by carefully constructed provisions of a public merger agreement. While typical non-solicitation provisions permit target company boards to engage with new bidders post-signing, so they may satisfy their fiduciary obligation to seek the best value reasonably available, a board may so engage only in compliance with various procedural protections built into the non-solicitation provision. Thus, even when a "fiduciary out" termination provision characterizes a termination fee as the jilted merger partner's "sole and exclusive" remedy, exclusivity usually is conditioned on the target board complying with these procedural protections.

Genuine Parts demonstrates that while Delaware courts seek to give effect to the intentions of parties to a public merger agreement as exemplified by their agreement's express terms, the courts will analyze seemingly straightforward language in the context of the overall agreement, sometimes leading to a result not foreseen by one of the parties.