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To Our Clients:

Ten Questions Raised by Paramount

The Paramount decision issued by the Delaware Supreme Court last Friday answers a number of questions that come up in structuring an acquisition or responding to a takeover bid:

1. Question. If the sale of a company is for cash, or securities other than voting stock in a public company that does not have a control group, what standard should be followed by the board of directors.

Answer. The Paramount decision holds that in a sale of control context the directors of the company have one primary objective — "to secure the transaction offering the best value reasonably available for the stockholders." See Question 5 below.

2. Question. Did Paramount hold that the poison pill is illegal?

Answer. No. Paramount did not invalidate the pill. To the contrary it cites approvingly the Household decision in which the pill was first sustained by the Delaware Supreme Court.

3. Question. Can the target of a hostile takeover bid still just say no?

Answer. Yes. The Paramount decision expressly states that it does not apply to a situation where a company is following its own strategic plan and has not initiated a takeover situation. Where the target of a hostile bid wishes to consider rejecting the bid and remaining independent it is critical that the board of directors follow the correct process and have the advice of an experienced investment banker and legal counsel. The Paramount decision lists the key considerations for the board weighing an acquisition or a takeover:

(a) the offer's fairness and feasibility,
(b) the proposed financing,
(c) the consequences of the financing,
(d) questions of illegality,
(e) the risk of nonconsummation,
(f) the bidder's identity, prior background and other business experiences, and
(g) the bidder's business plans for the company and their effects on all stockholder interests.

4. Question. If it is not a sale of control but rather a common stock merger with the combined company being a true public company, can you have no-shop and lock-up provisions?

Answer. Yes. The Paramount decision is expressly limited to the situation of a sale of control. It does not apply to the merger of two companies that results in a public company without a control group. However, the Paramount decision does have much to say about the reasonableness of no-shop and lock-up provisions. In light of the Paramount decision a no-shop provision that is limited to the company not initiating discussions with third parties but does not restrict responses to third party initiatives is indicated. A lock-up option or bust-up fee should also be reasonable in amount and not so material as to foreclose a third party bid. The decision indicates that a combination of a lock-up stock option and a bust-up fee that is not capped at an aggregate reasonable amount is likely to be held invalid. Also questionable are a put alternative to a lock-up stock option as is an alternative permitting noncash exercise. While it can be argued that the Paramount decision discussion of lock-up options, bust-up fees and no-shop provisions is limited to sale of control situations, the underlying theme of the decision signals caution. This is an area where more may well be less and too much may taint the independence of the board and jeopardize the deal.

5. Question. Is there any way to do a deal that is viewed as a sale of control without shopping or conducting an auction?

Answer. Yes. If on the basis of well considered expert advice the board determines it is more likely to get the best value reasonably available by not shopping or auctioning, then the board can authorize the transaction. In this situation the board should document the basis for its determination and should avoid any no-shop, lock-up option of bust-up fee provision that would impede a third party from competing. In the past the Delaware courts have approved a subsequent "market check" as a substitute for shopping prior to entering into an agreement and the Paramount decision does not reject that approach.

6. Question. In evaluating competing bids involving securities can the board decide that it prefers one security over the other?

Answer. Yes, but only within reasonable limits. The Paramount decision says, "a board of directors is not limited to considering only the amount of cash involved, and is not required to ignore totally its view of the future value of a strategic alliance. . . . When assessing the value of non-cash consideration, a board should focus on its value as of the date it will be received by the stockholders. Normally, such value will be determined with the assistance of experts using generally accepted methods of valuation." (Emphasis added)

7. Question. Does the Paramount decision change the role or duties of the directors?

Answer. No. The court in the Paramount decision cited with approval the prior Delaware cases which basically say that in acquisition transactions the directors must be especially diligent. The decision goes on to say "the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial."

8. Question. Can a company enter into a merger of equals (that is not a sale of control) in which neither company gets a premium?

Answer. Yes. The language in the Paramount decision that the shareholders of the acquired company must get a premium for the sale of control is expressly limited to the sale of control situations and does not apply to a merger of equals.

9. Question. If a company enters into a strategic merger that is not a sale of control in which the company gets a premium and a third party makes a hostile takeover bid for the company at a higher value to its shareholders, can the company cancel the merger and reject the hostile bid?

Answer. Yes, in theory, but as a practical matter there may be so much shareholder pressure that the company will be forced into the auction mode and be forced to accept the highest bid.

10. Question. In a transaction where it is permitted to use a bust-up fee, what is a reasonable amount?

Answer. The Paramount decision rejects an "unreasonable" bust-up fee but does not give guidance as to what is reasonable. Prior precedent and the Paramount decision's rejection of a $100 million bust-up fee as unreasonable when considered together with a lock-up option with a value of more than $400 million in a $10 billion transaction, provides some basis for the view that a bust-up fee of up to 2% is sustainable.

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