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Delaware Court of Chancery Delays Vote on CVS/Caremark Merger[1]

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In a decision that emphasizes the need for attention to all the circumstances surrounding the structuring of deals, the Delaware Court of Chancery issued a preliminary injunction postponing for at least 20 days a vote of the stockholders of Caremark RX, Inc. ("Caremark") on its proposed merger with CVS Corporation ("CVS").[3] Although the mere postponement of the vote appears to be unremarkable, the Court's decision merits attention because of the primary reason for the injunction – the Court treated a special dividend and a stock for stock merger as an integrated transaction and concluded that the Caremark stockholders were entitled to appraisal rights. In addition, the Court made interesting observations about termination fees and the structure of investment advisors' fees.

On November 1, 2006, Caremark and CVS entered into a merger agreement, subject to stockholder approval.[4] Six weeks later, Express Scripts, Inc. ("Express Scripts") submitted an unsolicited bid for Caremark that valued the company at $3 billion more than the value of the CVS transaction. After a series of meetings, the Caremark board determined that the Express Scripts offer did not constitute a "superior proposal" within the meaning of the CVS merger agreement, and issued a press release announcing its intention to continue to pursue the merger

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[3] *Louisiana Municipal Police Employees' Retirement System v. Crawford*, 2007 WL 582510 (Del. Ch. Feb. 23, 2007), *appeal denied*, C.A. No. 2663-N (Del. Mar. 9, 2007). In another decision of interest to dealmakers, the Court of Chancery previously postponed a meeting of Caremark stockholders to provide additional time for stockholders to review supplemental disclosures. *Louisiana Municipal Police Employees' Retirement System v. Crawford*, 2007 WL 417193 (Del. Ch. Feb. 13, 2007). Caremark had issued supplemental disclosure about its previous contacts with interloper Express Scripts on February 12, 2007, in connection with a vote scheduled for February 20. The Court in its February 13 decision held that such time frame was insufficient to allow stockholders to make a fully-informed decision on the merger, particularly in light of the intervening holiday weekend.

[4] The parties contemplated that as a result of the merger, Caremark stockholders would own 45% of the combined company, and the board of directors and management positions would be shared equally.

with CVS.[5] In addition, CVS proposed that Caremark declare a special cash dividend of $2.00 per share prior to the effective time of the merger, to be paid simultaneously with or immediately after the consummation of the merger.[6] In response, Express Scripts commenced an exchange offer for all of the outstanding shares of Caremark on the same terms and conditions as its earlier submitted proposal. Caremark's board did not change its views on the Express Scripts offer and maintained its recommendation in favor of the CVS/Caremark merger. Plaintiffs, Caremark stockholders and Express Scripts, sought a preliminary injunction to enjoin the scheduled meeting of Caremark stockholders, alleging, *inter alia*, breach of fiduciary duty and aiding and abetting claims.

Although the Court found that certain aspects of the Caremark board's process in approving the CVS deal were "troubling," the Court denied plaintiffs' request for an order enjoining the meeting entirely. Instead, it enjoined the vote until 20 days after Caremark and CVS provided additional disclosure concerning the stockholders' right to seek appraisal and the structure of the fees to be paid to Caremark's investment bankers. In reaching this result, the Court focused on the addition of the special dividend to the terms of the CVS transaction. The Court concluded that the special dividend triggered the availability of statutory appraisal rights under Section 262 of the Delaware General Corporation Law.[7] In reaching that conclusion, the Court determined that Delaware's well-settled doctrine of independent legal significance[8] was not applicable to the proposed merger/special dividend structure**.** In reaching the decision that the special dividend was effectively cash consideration to be paid to Caremark stockholders as part of the proposed merger with CVS, the Court was persuaded by the fact that the payment of the special dividend was proposed by CVS as a response to Express Scripts offer, was specifically conditioned on stockholder approval of the merger agreement, and would only become payable if the merger with CVS closed.[9] In that regard, the Court emphasized that Section 262 "grants appraisal rights

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[5] The Caremark board cited, *inter alia*, its determination to pursue a strategic merger, Caremark clients' reluctance to work with Express Scripts, and the concern that the combined Caremark/Express company would be highly leveraged.

[6] Following the distribution of supplemental disclosure, the special dividend was increased to $6 per share.

[7] Absent the special dividend, the Caremark stockholders would not have been entitled to appraisal rights as a result of the stock for stock merger because of the "market out" exceptions of the appraisal statute, Section 262. 8 *Del. C.* § 262(b)(1).

[8] The doctrine of independent legal significance provides that an action taken under one section of the Delaware General Corporation Law is legally independent, and its validity is not dependent upon, nor to be tested by the requirements of other unrelated sections under which the same final result might be attained by different means. *See, e.g., Rothschild Int'l Corp. v. Liggett Group Inc.*, 474 A.2d 133, 136 (Del. 1984); *Warner Communications, Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962, 970 (Del. Ch.), *aff'd*, 567 A.2d 419 (Del. 1989) (TABLE).

[9] The Court concluded that those "facts belie the claim that the special dividend has legal significance independent of the merger" and thus "the label 'special dividend' is simply cash consideration dressed up in a none-too-convincing disguise." 2007 WL 582510, at *12. If Caremark's Board had declared a cash dividend payable whether or not the CVS transaction closed, presumably the results would have been different.

to stockholders who are required, by the terms of the merger, to accept" cash consideration for their shares. [10]

In addition to its findings about the inextricable link between the merger and the special cash dividend, the Court's decision on appraisal rights also appears to reflect its apparent skepticism about the Caremark board's decision to continue to recommend the CVS/Caremark merger, despite the existence of a competing premium offer from Express Scripts. In particular, the Court stated that the Caremark stockholders "should not be denied their appraisal rights simply because their directors are willing to collude with a favored bidder to 'launder' a cash payment."[11] In the end, the Court determined to postpone, and did not indefinitely enjoin, the vote, finding that there was neither irreparable harm nor extraordinary inequity because the stockholders would have the opportunity to vote in a fully-informed manner on the CVS/Caremark merger, supported by the protection of the appraisal remedy.

The Court's skepticism about the Caremark board's process is evidenced by its discussion of the personal benefits to be received by Caremark's officers and directors as a result of the CVS/Caremark merger. Those benefits included (i) cash payments payable to many of the directors and officers pursuant to certain change of control provisions in their employment agreements (even though defendants insisted that the transaction did not constitute a "change of control" for purposes of *Revlon*),[12] and (ii) structural and contractual protections from potential liability from the Caremark option backdating scandal.[13] The Court noted that it was not clear that a third party bidder would offer those same benefits in a superior proposal.[14]

The Court found the contractual liability protections to be particularly troubling. The surviving company agreed not only to contractually honor any grant of options by Caremark, but also, and most significantly, to indemnify all past and present directors of Caremark "to the fullest extent permitted by law."[15] The Court viewed the indemnity agreement as powerful protection because it potentially provided the Caremark board, and particularly the independent

[10] 8 *Del. C.* § 262(b)(2), (stating the "cash exception" to the market out). That Section provides appraisal rights are available if stockholders "are required by the terms of an agreement of merger…to accept for such stock anything other than [publicly traded stock or ADRs]."

[11] *Id.* Indeed, the Court found that it was CVS, not Caremark, that initially proposed the dividend in response to the Express Scripts offer.

[12] Pursuant to the change of control provisions, upon consummation of the CVS/Caremark merger, many executives' options would accelerate and become immediately exercisable, and deferred compensation plans would pay out immediately. The Chancellor stated that it is "an unfortunate and disappointing spectacle … to watch a board of directors insist that it simultaneously deserves the protection of the business judgment rule because the company is not changing hands, while a massive personal windfall is bestowed because it is." *Id.* at *3 n.6.

[13] *See In re Caremark, Rx., Inc. Deriv. Litig.*, Master Docket No. 3:06-cv-00535 (M.D. Tenn.).

[14] Although another merger may also constitute a "change of control" for purposes of the employment contracts, the Court noted that the bidder may require the renegotiation of such agreements. Moreover, the Court observed that the agreement of Caremark's Chairman to reduce his severance package by $10 million in connection with the CVS transaction may not apply to an alternate merger implicating change of control rights, effectively increasing the termination fee by $10 million.

[15] *Id.* at *10.

directors, with indemnification rights that Caremark itself might not have been able to provide the directors.[16] This potential increase in coverage was important because it potentially could relieve the Caremark directors of liability to Caremark for allegedly manipulating the grant date of options.[17]

As for deal protections, the Court again emphasized, as it had in *Toys "R" Us*, the context-specific analysis required to determine the reasonableness of deal protection mechanisms.[18] Most interestingly, the Court rejected, with some emphasis, the contention that the Court should accept certain deal protection measures as *per se* reasonable simply because they are customary.[19] In that regard, the Court refused to find that a 3% termination fee was *per se* valid, instead noting that the Court will consider a number of factors in determining the reasonableness of the fee as part of an overall package of deal protection. The factors to be considered include, without limitation,

> the overall size of the termination fee, as well as its percentage value; the benefit to the shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole.[20]

The Court also found that a postponement of the stockholder vote was necessary to provide the Caremark stockholders with additional disclosure relating to the structure of the contingent

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[16] Delaware corporate law limits indemnification for liability to the corporation and requires indemnitees to have acted in good faith and in the best interests of the corporation. 8 *Del. C.* § 145. Directors and officers acting in contravention of their duty of loyalty may be subject to personal liability. 8 *Del. C.* § 102(b)(7). In respect of the instant case, however, "[i]ndemnity owed to former Caremark directors from CVS/Caremark … arguably arises under contract law and outside the restrictions of statutory corporate law. … Were a backdating case later to come to trial, Caremark directors would almost certainly argue that Delaware statutory law puts no direct limitations on such beneficence." 2007 WL 582510, at *3 n.8. Under such circumstances, indemnification arguably would be subject only to the limits of public policy.

[17] *See In re Tyson Foods, Inc. Consol. S'holder Litig.*, 2007 WL 416132 (Del. Ch. Feb. 6, 2007) (granting in part and denying in part a motion to dismiss breach of fiduciary duty claims in connection with alleged grants of "spring-loaded" stock options). The Court suggested that the increased indemnification rights could be particularly important for Caremark's independent directors who may otherwise be subject to personal liability even though they did not receive a corresponding benefit from the grant of allegedly backdated options. 2007 WL 582510, at *3 n.8.

[18] *See In re Toys "R" Us, Inc., S'holder Litig.*, 877 A.2d 975, 1016 (Del. Ch. 2005). The "intricate barricade" of deal protection devices included a "force the vote" provision, a "no shop" provision, "last look" rights, and a $675 million reciprocal termination fee, representing 3% of the transaction value. 2007 WL 582510, at *3-4.

[19] The Court stated that a "3% rule" for termination fees "is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule." *Id.* at *4, n.10. On the other hand, plaintiffs are likewise precluded from relying on a "naturally-occurring rate or combination of deal protection measures, the existence of which will invoke the judicial blue pencil." *Id.* Rather, the burden remains with plaintiffs to show that a particular *set* of deal protection measures are inequitable in the circumstances present in a particular transaction.

[20] *Id.*

portion of the fee payable to Caremark's financial advisors. The Court found that the fee disclosure was misleading because it did not clearly state that the financial advisors were entitled to the contingent fee only if Caremark approved a merger with CVS (and not another party). The Court concluded that "where a significant portion of bankers' fees rests upon initial approval of a particular transaction, that condition must be specifically disclosed" to stockholders.[21]

The *Caremark* decision emphasizes the need for understanding the context in which courts will review transactions in structuring deals. The Court's treatment of the special dividend and the merger as an integrated transaction, to which the doctrine of independent legal significance was not applicable, demonstrates the unavoidable fact that the Delaware courts will examine deal structures in view of the particular circumstances and the parties' negotiating history in deciding whether to apply the doctrine in a particular case.[22] In our view, the decision should be read narrowly, as applicable to the unique facts of the case, including the fact that (i) the special dividend was contingent on and payable only in connection with closing of the merger and was viewed by the Court as a mechanism by which the directors were colluding with a bidder to favor a deal that arguably benefited the directors personally, and (ii) the availability of the appraisal remedy permitted the Court to merely postpone, and not completely enjoin, the vote. Indeed, the Court recognized the narrow reach of its holding when it later denied a motion by the plaintiffs to certify an interlocutory appeal to the Delaware Supreme Court.[23] In that decision, the Court reconsidered the independent legal significance argument and found it to be "absolutely meritless" particularly because Caremark essentially had admitted in its briefing that "the offer, in substance, includes cash consideration. . . ."[24] The Court indicated that it was "less than impressed by Caremark's attempt to attack this Court's decision on this point as inconsistent with the doctrine of independent legal significance, as Caremark's interpretation would make a mockery of the word 'independent' in that long-standing legal doctrine . . . ."[25] The decision also

[21] This case is another example of the Court of Chancery's willingness to carefully scrutinize investment banking fee arrangements. *See, e.g.*, *In re Tele-Communications, Inc. S'holders Litig*., 2005 WL 3642727, at *10 (Del. Ch. Dec. 21, 2005); *Toys "R" Us*, 877 A.2d at 1006.

[22] In this sense, the *Caremark* decision may be seen as consistent with a long line of Delaware cases in which Delaware courts have refused to give effect to conduct that was legally permissible but done with an "inequitable purpose." *See, e.g*., *Schnell v. Chris Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971). Moreover, *Caremark* involved a somewhat different fact pattern than the typical case in which independent legal significance has been applied. In the typical case, the Court is faced with an entire transaction that is structured under one method (*e.g*., a merger) rather than another method (*e.g*., an asset sale). Here, the structure involved a merger *and* a dividend.

[23] *See Louisiana Municipal Police Employees' Retirement System v. Crawford*, C.A. Nos. 2635-N, 2663-N (Del. Ch. Mar. 7, 2007) (Transcript).

[24] *Id*. at 23. The Court was also persuaded by the fact that the merger agreement had precluded the Caremark board from having the independent authority to declare a dividend, and that it was only because of CVS' agreement to waive that prohibition that the special dividend could be paid. Thus, the Court suggested that the Caremark stockholders might not be receiving cash in exchange for their shares, but "they'll receive a certain number of CVS shares and an agreement from CVS that no lawsuit for breach of contract or imposition of a CVS 'payment event' will occur if Caremark's board issues two unanticipated dividends. That's the effect of CVS'[] waiver of the exceptions clause in the merger agreement, and it's the very purpose behind CVS allowing Caremark to pay the dividend if and only if the merger is consummated at or after the merger's effective date." *Id.* at 24-25.

[25] *Id*. at 26.

suggests that practitioners should bear in mind, when negotiating financial advisory fees, the disclosure that will be required of those arrangements, and cautions against placing undue emphasis on the “precedential” value of termination fees negotiated in different contexts.