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Caveat Emptor: Contractual Indemnification Provisions in Acquisition Agreements and Resulting Acquirer Risk for Unknown Actions of Target Fiduciaries

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Transactions involving public companies in today's M&A environment are all but certain to be challenged by target stockholders.[1] At least in part because of this phenomenon, targets of acquisitions typically demand that acquirers agree to indemnify their directors and officers for expenses and liabilities incurred in connection with litigation challenging the transaction. Although indemnification obligations embedded in acquisition agreements are creatures of contract and can vary significantly, recent cases highlight the nontrivial risk that acquirers may be unknowingly exposing themselves to indemnification obligations that the target itself would be prohibited from providing under Delaware law.

This risk arises in part from the limited scope of Delaware's statutory restrictions on indemnification. Section 145 of the Delaware General Corporation Law ("DGCL") restricts the ability of Delaware corporations to indemnify their own directors and officers for expenses and liabilities arising out of third-party actions (*e.g.*, stockholder class actions challeng-

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From the EDITOR

Busy Days in Delaware

Each article in our current issue is concerned in some manner with recent decisions from the Delaware courts. That said, the topics under consideration range far and wide. Our lead article, for instance, examines three relatively recent decisions that "highlight the nontrivial risk that acquirers may be unknowingly exposing themselves to indemnification obligations that the target itself would be prohibited from providing under Delaware law. This risk arises in part from the limited scope of Delaware's statutory restrictions on indemnification." As the authors Bradley Aronstam and A. Thompson Bayliss write, "while none of the cases delved substantively into the issue, all three recognized the possibility that acquirers may be able to extend indemnification rights beyond the limits of Section 145."

This is a critical point, as until the common law limits on director and officer indemnification are better understood, the authors argue that acquirers should make clear in agreements that their indemnification obligations "are limited in scope to conduct that could be indemnified by the target (*i.e.*, those within the province of Section 145)," they note. "Sellers, on the other hand, may seek to impose broader indemnification obligations where possible."

A more recent case of note is the Delaware Court of Chancery's ruling in *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*. The case challenged a broadly held assumption of M&A practitioners—that the acquisition of a target company through the common "reverse triangular merger" structure does not result in the assignment of the contracts of the target by operation of law or otherwise, as Debevoise & Plimpton's Jonathan Levitsky and Dmitriy Tartakovskiy write.

"The issue is important because while most commercial contracts prohibit assignment without the consent of the counterparty, provisions granting a termination right or other remedy in the event of a change of control are less common," the authors note. (For another excellent perspective on the *Meso* decision by Sherman and Sterling's Michael Kennedy, please see the May 2013 issue of our sister publication, *Wall Street Lawyer*.)

Also, Sullivan & Cromwell's Krishna Veeraraghavan and Jason Tyler examine what they describe as an "uncertain relationship" between fiduciary waivers and the implied covenant of good faith in Delaware alternative entity law. As the authors write, "the risk is that Delaware's implied covenant doctrine "seems" to open a backdoor to fiduciary review that, as the Court of Chancery has described it, is "tempting" to plaintiffs and plaintiffs' firms. Furthermore, until that backdoor definitively is shut, unaffiliated equity holders have at least a colorable legal theory on which to initiate litigation against alternative entities and those who manage them."

Finally a trio of Sidley Austin attorneys, Scott Freeman, Gabriel Saltarelli and Robert Higgins, dig into the Delaware courts' recent scrutinizing of the use of "don't ask, don't waive" standstill provisions, and note that "recent bench rulings in the Delaware Chancery Court suggest that, because DADW standstill provisions are powerful tools, they should be used only under close supervision by the board of directors."

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MANAGING EDITOR

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ing acquisitions) to situations where the directors and officers acted "in good faith and in a manner [they] reasonably believed to be in or not opposed to the best interests of the corporation."[2] But Section 145 only expressly applies to circumstances in which a corporation has agreed to extend indemnification to *its own* directors and officers. Courts in and outside Delaware have signaled that indemnification obligations created by contracts with third parties in this setting are not subject to this statutory constraint and therefore could potentially require indemnification for bad faith conduct. Thus, acquirers agreeing to provide indemnification to target fiduciaries "to the fullest extent permitted by law" may find themselves on the hook for latent loyalty breaches unlikely to come to light until after the execution of the acquisition agreement (if not after closing).

As discussed below, there is a different line of authority suggesting that agreements to indemnify for intentional misconduct may be unenforceable on public policy grounds, but the courts have yet to explore or define the contours of those common law limits in the director and officer setting. Until the common law limits on director and officer indemnification are better understood, the key takeaway for acquirers and their advisers is evident: acquisition agreements should make clear that the acquirer's indemnification obligations are limited in scope to conduct that could be indemnified by the target (*i.e.*, those within the province of Section 145). Sellers, on the other hand, may seek to impose broader indemnification obligations where possible. Acquirers considering or agreeing to provide indemnification "to the fullest extent permitted by law" should therefore proceed on an informed basis with their eyes wide open after weighing the potential risks.

Company Indemnification for Directors and Officers

Section 145(a) of the DGCL authorizes Delaware corporations to indemnify their own directors and officers (so-called "Company Indemnification") "against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement" in lawsuits brought by third parties, but only if the directors and officers "acted in good faith and in a manner [they] reasonably believed to be in or not opposed to the best interests of the corporation."[3] Delaware courts have interpreted Section 145(a) "as not authorizing the use of contracts to grant advancement and indemnification rights that are 'contrary to the limitations or prohibitions set forth in the other section 145 subsections, other statutes, court decisions, or public policy.'"[4] Thus, a Delaware corporation may only indemnify one of its own directors or officers where the director or officer acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation.

Third-Party Indemnification for Directors and Officers

The statutory limits imposed by Section 145 on a corporation's ability to indemnify its own directors and officers do not expressly apply in other contexts. Thus, an indemnification obligation owed by another entity (so-called "Third-Party Indemnification") operates beyond the express scope of Section 145 in a context where the only potential limits on indemnification arise from common law.[5] Accordingly, unless limited by common law, Third-Party Indemnification potentially allows indemnification for breaches of the fiduciary duty of loyalty involving scienter, including claims involving willful misconduct.

The Distinction Between Company Indemnification and Third-Party Indemnification in Case Law

At least three court decisions have contrasted the potential differences between Company Indemnification governed by Section 145 and Third-Party Indemnification in acquisition agreements. While none of the cases delved substantively into the issue, all three recognized the possibility that acquirers may be able to extend indemnification rights beyond the limits of Section 145.

Louisiana Municipal Police Employees' Retirement System v. Crawford

The Delaware Court of Chancery commented on the indemnification rights of the directors of Caremark Rx, Inc. ("Caremark") in litigation challenging CVS Corporation's acquisition of Caremark at a time when Caremark was embroiled in litigation arising out of the alleged backdating of stock options.[6] The governing merger agreement contained a provision in which CVS agreed to indemnify Caremark's directors to "the same extent such individuals [would be] indemnified pursuant to Caremark's certificate of incorporation" or "*the fullest extent permitted by law.*"[7] As noted by then-Chancellor Chandler, the indemnification rights of the former Caremark directors were "not merely coterminous with Caremark's former indemnification, but span[ned] '*the fullest extent permitted by law*,' [which] may be quietly critical."[8]

The Court explained that while a "corporation may only indemnify its own directors to the extent that a director acts in good faith and in the best interests of the corporation and, therefore, may not eliminate or limit the liability of a director who acts in violation of their duty of loyalty,"[9] "[i]ndemnity owed to former Caremark directors from CVS/Caremark . . . arguably arises under contract law and outside the restrictions of statutory corporate law."[10] The Court further recognized that "[i]n effect, CVS shareholders [we]re offering to indemnify Caremark directors,"[11] and observed that "[w]ere a backdating case later to come to trial, Caremark directors would almost certainly argue that Delaware statutory law puts no direct limitation on such beneficence."[12]

Indiana State District Council of Laborers v. Brukardt

In *Indiana State District Council of Laborers v. Brukardt*,[13] a Tennessee appellate court held that a third-party corporate acquirer (Fresenius Medical Care AG) was not bound by the restrictions of Section 145 and therefore could indemnify the defendant directors and officers of Renal Care Group, Inc. for "breaches of the duty of loyalty and good faith."[14] Relying on *Crawford*, the Court held that a merger provision providing indemnity "*to the fullest extent permitted by law*" would operate to indemnify the target company's fiduciaries for those breaches.[15] As explained by the Court:

> **[A]s a matter of Delaware law, Renal Care could only indemnify defendants for "acts in good faith and in the best interests of the corporation." But Fresenius, as a third party indemnifying Renal Care directors, is not bound by "the restrictions of statutory corporate law" and can extend indemnifications to defendants for breaches of the duty of loyalty and good faith. In other words, the indemnification offered by Fresenius covers defendants' liability for option backdating, a breach of the duty of good faith, whereas the indemnification offered to defendants by Renal Care could not.[16]**

In re Massey Energy Co. Derivative and Class Action Litigation

Then-Vice Chancellor Strine noted the same distinction flagged in *Crawford* and *Brukardt* in stockholder litigation challenging Alpha Natural Resources Inc.'s ("Alpha") acquisition of Massey Energy Co. ("Massey").[17] The original draft of the merger agreement proposed by Massey "required Alpha to indemnify the Massey defendants for any claim asserted against them in their capacity as Massey directors or officers '*to the fullest extent permitted by Law*.'"[18] The Court emphasized that "the draft merger agreement's indemnification provision arguably could have allowed Alpha, because it was a third-party and not Massey itself, to indemnify former Massey management and directors beyond the extent Massey itself would have been permitted under Delaware public policy and statutory law."[19] Alpha resisted this broad obligation in the negotiations, and Massey ultimately agreed that its directors and officers would only be permitted "the same protection they were afforded by Massey's certificate of incorporation."[20] According to the Court, "[t]his [formulation] did not immunize Massey directors or officers from liability to Massey or Alpha for non-exculpated breaches of fiduciary duty that harmed Massey."[21]

A Result Envisioned by the Drafters of Section 145?

Although the *Crawford*, *Brukardt* and *Massey* courts envisioned the possibility of indemnification beyond the limits contemplated by Section 145, the commentators who participated in the creation of that statutory section apparently did not. In recommendations that provided the backbone of the 1967 revisions to the DGCL, Professor Ernest Folk emphasized that "[w]hile indemnifying executives for many risks of office is . . . to be favored, this objective is not satisfactorily achieved by wording the indemnification statute so broadly that its language authorizes indemnification in obviously inequitable situations."[22] Similarly, Samuel Arsht and Walter Stapleton noted in their commentary on the 1967 amendments that "revision was appropriate with respect to the limitations which must necessarily be placed on the power to indemnify in order to prevent the statute from undermining the substantive provisions of the criminal law and corporation law."[23] Obviously, to the extent that Third-Party Indemnification could fill the void created by Section 145's limits on Company Indemnification, it could undermine what these commentators described as the purpose of Section 145's limits.[24]

Trap for the Unwary or Tempest in a Teapot?

The emphasis in *Crawford*, *Brukardt* and *Massey* on the distinction between Company Indemnification and Third-Party Indemnification suggests that courts are at least willing to entertain the possibility of indemnification for conduct that fails to satisfy the standard of conduct requirements embedded in Section 145. However, none of the cases examined common law limits on indemnification. Those limits could be interpreted to minimize, eliminate or even reverse the distinction raised in *Crawford*, *Brukardt* and *Massey* between Company Indemnification and Third-Party Indemnification.

In *James v. Getty Oil Co.*,[25] the Delaware Superior Court emphasized that "[a] contract to relieve a party from its intentional or willful acts is invariably held to be unenforceable as being against clear public policy."[26] The Restatement (Second) of Contracts (the "Second Restatement") similarly provides that "[a] term exempting a party from tort liability for harm caused intentionally or recklessly is unenforceable on grounds of public policy."[27] If either of the tenets articulated in *James* or the Second Restatement is the common law of Delaware, then Third-Party Indemnification might in fact be narrower (rather than broader) than Company Indemnification. Stated differently, Section 145 could be read to abrogate more restrictive common law limits on indemnification by expressly authorizing indemnification for intentional, willful and reckless acts, so long as the indemnitee acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation.[28]

Resulting Risk for Acquirers

Last year's well-publicized decision in *In re El Paso Corporation Shareholder Litigation*[29] highlights the risks posed to acquirers in this context. *El Paso* arose out of Kinder Morgan's agreement to acquire the El Paso Corporation for more than $35 billion. Stockholder plaintiffs argued that El Paso's CEO, who negotiated the deal on behalf of El Paso and was thus charged with maximizing value for the company's stockholders, privately coveted the exploration and production ("E&P") division of El Paso that Kinder Morgan intended to divest after the merger. The stockholder plaintiffs claimed that this supposed interest, and the failure to disclose conversations surrounding it, tainted the sales process.

Although Chancellor Strine denied the stockholder plaintiffs' motion for a preliminary injunction, he expressed serious concern over these claims. As explained by the Chancellor, "for an MBO to be attractive to management and to Kinder Morgan, not forcing Kinder Morgan to pay the highest possible price for El Paso was more optimal than exhausting its wallet, because that would tend to cause Kinder Morgan to demand a higher price for the E&P assets."[30] Based on the preliminary injunction record before him, the Court concluded that "the supposedly well-motivated and expert CEO entrusted with all the key price negotiations kept from the Board his interest in pursuing a management buy-out of the Company's E&P business."[31] In short, "when El Paso's CEO was supposed to be getting the maximum price from Kinder Morgan, he actually had an interest in not doing that."[32]

The evidentiary record before the Chancellor at the preliminary injunction stage was necessarily limited, and El Paso's CEO ardently contested—and intended to vigorously defend—plaintiffs' claims. But crediting those claims solely for illustrative purposes, a duty of loyalty breach would have been a distinct possibility.

Critically, long before any allegations of this undisclosed interest had come to light, Kinder Morgan entered into a merger agreement with a provision that obligated it to indemnify El Paso's directors and officers "to the fullest extent permitted under applicable law." Specifically, Section 5.8(b)(i) of the governing merger agreement required Kinder Morgan to:

> *indemnify and hold harmless* **against any cost or expenses (including attorneys fees), judgments, fines, losses, claims, damages or liabilities and amounts paid in settlement in connection with any Proceeding, and provide advancement of expenses to, all Indemnified Persons** *to the fullest extent permitted under applicable Law.*[33]

Thus, while Section 145 would have prohibited El Paso from indemnifying its CEO for a breach of the duty of loyalty, Kinder Morgan as a third-party buyer arguably would have had indemnification obligations. This risk was neither trivial nor academic: the Chancellor expressly stated that El Paso's CEO might be liable for damages in the hundreds of millions of dollars.

Conclusion

Eliminating similar risk for acquirers going forward is simple and straightforward (at least as a drafting matter). Acquirers and their advisors need only make clear in their acquisition agreements that buy-side indemnification obligations are limited in scope to conduct that could be indemnified by the targets (*i.e.*, those within the scope of Section 145). To the extent that targets resist, acquirers should only accede to expansive "to the fullest extent permitted by law" indemnification language with knowledge of the potential risks, at least until the Delaware courts definitively address the scope of the common law limits on Third-Party Indemnification in the director and officer setting.

NOTES

1. *See* Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions*, CORNERSTONE RESEARCH (February 2013 Update), *available at* http://www.cornerstone.com/files/News/b8ef7851-5ff6-4247-aaf3-7b211080adc2/Presentation/NewsAttachment/7d8db313-246d-4015-b075-94075aae2c39/Cornerstone_Research_Shareholder_Litigation_Involving_M_and_A_Feb_2013.pdf, at 1 ("Continuing a recent trend, shareholders challenged the vast majority of M&A deals in 2012. Among deals valued over $100 million, 93 percent were challenged, with an average of 4.8 lawsuits filed per deal... . For deals valued over $500 million, 96 percent of target firms reported deal-related litigation in their Securities and Exchange Commission (SEC) filings . . . , with an average of 5.4 lawsuits per deal.").
2. 8 *Del. C.* § 145(a).
3. 8 *Del. C.* § 145(a). Section 145(a) provides in its entirety as follows: *A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorney's fees), judgments, fines and amounts*

paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was unlawful. In contrast to Section 145(a), a corporation has no power under Section 145(b) to indemnify "amounts paid in settlement" in an action brought "by or in the right of the corporation" (e.g., a derivative action brought on behalf of the corporation). *See 8 Del. C. § 145(b)*.

4. *Sun-Times Media Grp., Inc. v. Black*, 954 A.2d 380, 404 n.93 (Del. Ch. 2008) (quoting *Cochran v. Stifel Fin. Corp.*, 2000 WL 286722, at *18 (Del. Ch. Mar. 8, 2000), *rev'd on other grounds*, 809 A.2d 555 (Del. 2002)); *see also In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 65-66 (Del. 2006) ("To oversimplify, subsections (a) and (b) of [Section 145] permit a corporation to indemnify . . . where (among other things) . . . that person 'acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation"); *VonFeldt v. Stifel Fin. Corp.*, 1999 WL 413393, at *2 (Del. Ch. June 11, 1999) ("[A]s far as § 145 is concerned, Delaware corporations lack the power to indemnify a party who did not act in good faith or in the best interests of the corporation.").

5. *See, e.g., Pike Creek Chiropractic Ctr., P.A. v. Robinson*, 637 A.2d 418, 419-20 (Del. 1994) (enforcing an indemnification provision whereby an employee agreed to indemnify his employer for any liabilities "which result from any acts and [omissions] of the Employee"); *Agassi v. Planet Hollywood Int'l, Inc.*, 269 B.R. 543, 552 (D. Del. 2001) (enforcing several celebrities' contractual indemnification rights where the contract provided for reimbursement of attorneys' fees "arising from or in any way relating to the financing[,] promotion or operation of the restaurants") (emphasis omitted). This private ordering among commercial parties is subject only to policy constraints. *See, e.g., Davis v. R.C. Peoples, Inc.*, 2003 WL 21733013, at *4 n.24 (Del. Super. Ct. July 25, 2003) (stating that parties can obtain contractual indemnification for their own negligence if the contract provisions are "crystal clear and unequivocal") (quoting *State v. Interstate Amiesite Corp.*, 297 A.2d 41, 44 (Del. 1972)). Notably, Delaware law imposes one additional statutory limitation on indemnification in 6 *Del. C.* § 2704, but this limitation expressly applies only to obligations in construction contracts purporting to provide indemnification for damages arising from liability for bodily injury or death caused by, resulting from, or arising from the negligence of the indemnitee or others.

6. *Louisiana Mun. Police Emps.' Ret. Sys. v. Crawford*, 918 A.2d 1172 (Del. Ch. 2007).
7. *Id*. at 1180 (emphasis added).
8. *Id*. at 1180 n.8 (emphasis added).
9. *Id*. (emphasis omitted).
10. *Id*.
11. *Id*.
12. *Id*.
13. 2009 WL 426237 (Tenn. Ct. App. Feb. 19, 2009).
14. *Id.* at *12.
15. *Id*. (emphasis added).
16. *Id*.
17. *In re Massey Energy Co. Deriv. & Class Action Litig.*, 2011 WL 2176479 (Del. Ch. May 31, 2011).
18. *Id*. at *16 (emphasis added).
19. *Id*.
20. *Id*. at *17.
21. *Id*.
22. Ernest L. Folk, III, REVIEW OF THE DELAWARE CORPORATION LAW 76 (1967); *see also id*. at 77 (emphasizing that "too easy indemnification" might undercut fiduciary duties").
23. S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 77-78 (1967).
24. Courts and commentators have emphasized the same point when interpreting the "non-exclusivity" clause in Section 145(f) of the DGCL, which expressly provides that "[t]he indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise." *See, e.g.*, Ernest L. Folk, III, *Corporation Law Developments—1969*, 56 VA. L. REV. 755, 775 (1970) (noting that cases "seem to impose some limitations on indemnity under the non-exclusivity clause so as not to destroy the standards carefully articulated elsewhere

in the statute"); *Waltuch v. Conticommodity Servs., Inc.*, 833 F. Supp. 302, 309 (S.D.N.Y. 1993) ("[T]here would be no point to the carefully crafted provisions of Section 145 spelling out the permissible scope of indemnification under Delaware law if subsection (f) allowed indemnification in additional circumstances without regard to these limits. The exception would swallow the rule."), *aff'd in relevant part*, 88 F.3d 87 (2d. Cir. 1996).

25. 472 A.2d 33 (Del. Super. Ct. 1983).

26. *Id.* at 38 (citing 15 WILLISTON CONTRACTS § 1750A (3d ed.).

27. RESTATEMENT (SECOND) OF CONTRACTS § 195 (1981). When considering the potential application of § 195 of the Second Restatement, at least two issues warrant mention. First, the language that could be read to limit indemnification expressly applies only to "torts," and there is lingering uncertainty about whether a breach of fiduciary duty should be deemed a "tort," an "equitable tort," a breach of contract, or something else. *See* J. Travis Laster & Michelle D. Morris, *Breaches of Fiduciary Duty and the Delaware Uniform Contribution Act*, 11 DEL. L. REV. 71, 88-93 (2010). Second, in an analogous context, the Court of Chancery has expressly declined to adopt the rule set out in § 195. *See Abry Partners V L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1064 (Del. Ch. 2006) (holding that a contractual provision purporting to exculpate a seller who made contractual representations and warranties that it knew at the time were false was unenforceable as a matter of public policy, but that a contractual provision purporting to exculpate a seller who acted in a reckless manner was enforceable). In the words of then Vice-Chancellor Strine in *Abry*: "I recognize that I am drawing a different line than § 195 of the Restatement by drawing the line at lies rather than recklessly conveyed false statements. I do so because I think it both more efficient and fair only to override a contractual limitation on liability when that limitation would exonerate an actual liar or someone complicit in a lie." *Id.* at 1063 n.82.

28. Indemnification "to the fullest extent permitted by law" under Delaware's LP and LLC statutes is likely far more expansive. *See* 6 *Del. C.* § 18-108 (providing that, "[s]ubject to such standards and restrictions, if any, as are set forth in its limited liability company agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever"); 6 *Del. C.* § 17-108 (providing that, "[s]ubject to such standards and restrictions, if any, as are set forth in its partnership agreement, a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever"). Notably, this language could be read to abrogate the potential common law limits on indemnification addressed in this section.

29. 41 A.3d 432 (Del. Ch. 2012).

30. *Id.* at 444.

31. *Id*. at 443.

32. *Id*. at 434.

33. Emphasis added. Section 5.8(d) of the Merger Agreement further provided that "[t]he rights of any Indemnified Person under this Section 5.8 shall be in addition to any other rights such Indemnified Person may have under the New EP Surviving Corporation Certificate, the New EP Surviving Corporation By-Laws, the DGCL or the DLLCA."

A Hard Case Makes Good Law: *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*

BY JONATHAN E. LEVITSKY AND DMITRIY A. TARTAKOVSKIY

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Justice Holmes famously observed that "hard cases…make bad law,"[1] an adage that was neatly avoided in the Delaware Court of Chancery's recent ruling in *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*.[2] The case challenged a broadly-held assumption of M&A practitioners that has been historically less settled than many may have assumed—that the acquisition of a target company through the common "reverse triangular merger" structure does not result in the assignment of the contracts of the target by operation of law or otherwise.

The issue is important because while most commercial contracts prohibit assignment without the consent of the counterparty, provisions granting a termination right or other remedy in the event of a change of control are less common. Since in a reverse triangular merger a transitory merger subsidiary of the acquirer merges with and into the target company, with the target company surviving, the typical view is that no assignment of the target's contracts has occurred even though the target has experienced a change of control. As a consequence, reverse triangular mergers are generally thought to require fewer third-party consents than transactions structured as forward mergers or asset purchases, an important element in the appeal of this structure. Where the relevant contracts are material to the business, the need for such consents can be an important issue, giving the contractual counterparties hold-up value over the deal and creating transaction costs and uncertainty. In some instances, buyers may insist that obtaining counterparty consents for key contracts be a closing condition, or the allocation of the cost of failing to obtain necessary consents may be a matter for negotiation between the parties.

The Delaware Court of Chancery reaffirmed in *Meso Scale* the M&A bar's prevailing view on this issue. Vice Chancellor Parsons held that, under Delaware law, a reverse triangular merger where the target is the surviving entity generally does not result in an assignment by operation of law of a contract that is held by the surviving entity both before and after the merger. The decision clarified confusion resulting from the Vice Chancellor's own previous ruling in the same case (denying a motion to dismiss), in which he had suggested (apparently influenced by the "hard facts" of the case described below) that a reverse triangular merger might constitute an assignment by operation of law in certain circumstances.

Background

Meso Scale arose out of a series of license agreements pursuant to which the defendants, Roche Holding Ltd. and certain of its affiliates, licensed from BioVeris Corporation a patent portfolio. One of the BioVeris-Roche license agreements granted plaintiff Meso Scale Technologies, LLC certain rights with respect to the technology licensed to Roche, and contained a provision prohibiting any assignment by BioVeris of its rights to the licensed technology "by operation of law or otherwise" without Meso's prior written consent. The assignment provision did not, however, expressly require Meso's consent to a change of control or ownership of BioVeris.

As a result of several lawsuits challenging Roche's license to the patent portfolio, Roche ultimately decided to acquire BioVeris in order to retain its rights to use the licensed technology. The acquisition was structured as a reverse triangular merger, in which a wholly owned subsidiary of Roche was merged with and into BioVeris, with BioVeris surviving the merger, and was completed without Meso's consent. Following the completion of the merger came the events that appear to have given the court pause—Roche discontinued BioVeris' product lines, closed down its research and development plant and terminated its employees, retaining only title to the technology formerly licensed to Roche. Meso brought a claim for breach of contract, alleging that the merger constituted an assignment by operation of law of BioVeris' rights to the patent portfolio, which required Meso's prior consent under the license agreement.

Roche promptly moved to dismiss the action for failure to state a claim, arguing that a reverse triangular merger could never constitute an assignment by operation of law under Delaware law. In a memorandum opinion dated April 8, 2011, Vice Chancellor Parsons denied the motion.[3]

Noting that no Delaware case squarely addressed the issue, the Vice Chancellor stated that because the plaintiffs alleged that BioVeris was essentially gutted and converted into a shell company to hold the valuable licenses for Roche's benefit following the merger, there could be an issue of fact as to whether the parties to the license agreement intended Roche's actions to constitute an assignment "by operation of law or otherwise" forbidden under the license, which could not be resolved on a motion to dismiss.

Ruling of the Delaware Court of Chancery

In September 2012, Roche moved for summary judgment, arguing among other things that the BioVeris merger did not constitute an assignment by operation of law in violation of the license agreement. Focusing on the issue more closely, Vice Chancellor Parsons agreed with Roche's interpretation of the anti-assignment provision and granted the motion.

(A) Delaware merger statute makes clear that a reverse triangular merger is not an assignment

In reaching its conclusion, the court first analyzed the provisions of Delaware's corporation statute describing the legal effect of a merger. In particular, the court noted the statute provides that a merger results in the transfer of the non-surviving corporation's rights and obligations to the surviving corporation by operation of law. Reasoning by negative implication, the court concluded that no assignment or transfer of the rights and obligations of the surviving corporation occurs as a result of the merger. Accordingly, the court held that a reverse triangular merger generally is not an assignment, by operation of law or otherwise, of assets held by the surviving entity both before and after the merger, and therefore, the term "by operation of law or otherwise" used in the license agreement made clear that the parties did not intend the anti-assignment provision to apply to reverse triangular mergers.

(B) Roche's interpretation is consistent with the reasonable expectations of the parties

The court also held that Roche's interpretation of the anti-assignment provision was consistent with the reasonable expectations of the parties to the license agreement. The court observed that leading commentators have noted that a reverse triangular merger does not constitute an assignment or transfer of a target company's assets by operation of law, which is a reason this transaction structure is a preferred method of acquisition in a wide range of transactions. Based on that commentary, the court concluded that it was unlikely that the parties would have expected the anti-assignment provision in the license agreement to apply to reverse triangular mergers.

(C) Forward triangular mergers distinguished

In support of its claims, Meso argued that the court should look to prior Delaware cases that held that a provision covering assignment by operation of law extends to all mergers.[4] However, Vice Chancellor Parsons found that the cases cited by the plaintiffs were distinguishable because they involved forward triangular mergers where the target was not the surviving entity, whereas this case involved a reverse triangular merger in which BioVeris was the surviving entity. The court instead analogized reverse triangular mergers to stock acquisitions—which, by themselves, do not result in an assignment by operation of law under Delaware law. Vice Chancellor Parsons reasoned that both stock acquisitions and reverse triangular mergers involve changes in legal ownership, and therefore, the law governing these transactions should reflect parallel results.

Practical Implications

The *Meso Scale* decision has resolved the uncertainty created by the court's 2011 ruling on the motion to dismiss and reaffirmed the prevailing understanding among M&A practitioners that, under Delaware law, a transaction structured as a reverse triangular merger will not trigger anti-assignment provisions that do not expressly prohibit a change of control. Different outcomes may be possible, however, in other jurisdictions.

Indeed, the *Meso Scale* court declined to adopt the approach outlined in a 1991 federal case, *SQL Solutions Inc. v. Oracle Corp.*,[5] cited by the plaintiffs. In that case, the U.S. District Court for the Northern District of California held that a reverse triangular merger constituted an assignment of a software license, noting a federal interest in protecting holders of intellectual property rights licensed to third parties. In rejecting the plaintiffs' argument that Delaware should adopt the same rule, Vice Chancellor Parsons noted that the *SQL Solutions* approach would be inconsistent with Delaware's case law on stock acquisitions. *SQL Solutions* was recently cited favorably by the U.S. District Court for the District of New Jersey in *DBA Distribution Services, Inc. v. All Source Freight Solutions, Inc.*[6] In that case, the court determined, interpreting a contract governed by New Jersey law, that a provision barring assignment by operation of law was violated by a reverse triangular merger.

Counsel should not over-weight the importance of these decisions. Both *SQL Solutions* and *DBA Distribution* are unreported rulings that were not intended to have precedential effect. These decisions also pre-date *Meso Scale*, which given the Delaware Court of Chancery's role as a preeminent forum for the resolution of business disputes is likely to be given substantial weight in other jurisdictions. Where the preservation of a contract is of key importance to a target business, acquirers and their counsel should nonetheless proceed with appropriate care.

NOTES

1. *Northern Securities Co. v. United States*, 193 U.S. 197 (1904).
2. C.A. No. 5589-VCP, memo op. (Del. Ch. Feb. 22, 2013).
3. *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, C.A. No. 5589-VCP, memo op. (Del. Ch. Apr. 8, 2011).
4. The plaintiffs relied primarily on two cases for that proposition: *Star Cellular Telephone Co. v. Baton Rouge CGSA, Inc.*, 1993 WL 294847 (Del. Ch. Aug. 2, 1993), *aff'd*, 647 A.2d 382, 1994 WL 267285 (Del. 1994), and *Tenneco Automotive Inc. v. El Paso Corp.*, 2002 WL 453930 (Del. Ch. Mar. 20, 2002).
5. C.A. No. 91-1079, 1991 WL 626458 (N.D. Cal. Dec. 18, 1991).
6. C.A. No. 11-3901, 2012 WL 845929 (D.N.J. Mar. 13, 2012).

"Don't Ask, Don't Waive": Standstill Provisions in Light of Recent Delaware Cases

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Most confidentiality agreements entered into by public companies in connection with merger discussions (in an auction or otherwise) include standstill provisions that prohibit potential acquirers from making unsolicited offers for some period of time. Many of these provisions prohibit the potential acquirer from even asking the target company to waive a prohibition in order to permit the potential acquirer to make a friendly acquisition proposal. The Delaware courts have recently scrutinized the use of such "don't ask, don't waive" ("DADW") standstill provisions. Recent bench rulings in the Delaware Chancery Court suggest that, because DADW standstill provisions are powerful tools, they should be used only under close supervision by the board of directors. We believe that, in most cases, the DADW standstill provisions should be drafted to permit the potential acquirer to make unsolicited acquisition proposals privately to the board of directors if the target company enters into a merger agreement with another party. This approach allows the target's directors to meet their ongoing obligation to evaluate all relevant information when deciding whether to continue to recommend the merger agreement to shareholders, in keeping with their fiduciary duties under Delaware law, and in fact is generally consistent with maximizing value for shareholders.

Treatment of Standstill Provisions by the Delaware Courts

While DADW standstill provisions have been analyzed on numerous occasions by the Delaware courts, the courts' treatment of these provisions has been inconsistent and has left open questions as to the appropriate use and the enforceability of DADW standstill provisions in the sale process.

In re Complete Genomics

In *In re Complete Genomics Inc. Shareholder Litigation*, Vice Chancellor Laster compared DADW standstill provisions to bidder-specific no-talk clauses, which prohibit a target not only from soliciting superior offers or providing information to third parties, but also from communicating with third parties about a sale of the target.[1] Vice Chancellor Laster found that "by agreeing to this [DADW] provision, the Genomics board impermissibly limited its ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders."[2] It is worth noting that Vice Chancellor Laster, in his oral ruling on November 9, 2012, denied the plaintiffs' request for a preliminary injunction barring Genomics from enforcing the standstill (as it was obligated to do under the merger agreement) because, at that time, he "understood that each standstill agreement prevented the counterparty from publicly requesting or proposing that the company or any of its representatives amend, waive, or consider amending or waiving any of its terms, but did not prevent the counterparty from making a non-public request."[3] The defendants, however, subsequently submitted a letter advising that the standstill for "Party J" contained a DADW standstill provision that prevented a party from making a non-public request for a waiver to the board. Vice Chancellor Laster felt this prevented the Genomics board from being able "to take into account that request and any of its terms when evaluating its ongoing statutory and fiduciary obligations to determine whether to continue to recommend in favor of the merger"[4] and he enjoined Genomics from enforcing the "Don't Ask Provision, insofar as such term purports to forbid Party J from seeking, in a non-public manner, a waiver of the terms of the Standstill Agreement."[5]

In re Celera

In *In re Celera Corporation Shareholder Litigation,*[6] the court commented on DADW standstill provisions in the context of approving a proposed settlement. Vice Chancellor Parsons separately analyzed and acknowledged the potentially value maximizing benefits of both DADW standstill provisions in confidentiality agreements and non-solicitation (or "no-shop") provisions in merger agreements. He noted that "[t]aken together, however, the Don't-Ask-Don't-Waive Standstills and No Solicitation Provision are more problematic …"[7] The court found the interplay of the DADW standstill provision with the non-solicitation provision troubling because, on the one hand, the DADW standstill provision blocks once-interested parties from informing the target board of their desire to bid and, on the other hand, the non-solicitation provision prevents the board from inquiring further into any potential interest from those parties. The result is that there is "at least a colorable argument that these constraints collectively operate to ensure an informational vacuum … [and increase] the risk that the Board would outright lack adequate information argu[ably] emasculat[ing] whatever protections the No Solicitation Provision's fiduciary out otherwise could have provided."[8] Vice Chancellor Parsons found that such "willful blindness" could mean the target board "would lack the information to determine whether continued compliance with the Merger Agreement would violate its fiduciary duty to consider superior offers" and even went so far as to say that merely "contracting into such a state conceivably could constitute a breach of fiduciary duty."[9]

In re Ancestry

In the most recent Delaware decision, *In re Ancestry*,[10] Chancellor Strine struck a different note with respect to DADW standstill provisions, holding that they are not *per se* invalid and that they can be used to encourage auction participants to make the fullest possible bids, but that their use should be monitored by the Board and disclosed to shareholders in the proxy statement.[11] The court noted that *Genomics* and *Celera* were not *per se* invalidations of DADW standstill provisions, but the courts' treatment of them should serve as an acknowledgement of the potency of these provisions and resultant obligation of directors to use them very carefully, such that their use remains consistent with the directors' fiduciary duties.[12] The court did not rule out the possibility that these provisions can be used as a "gavel" to maximize shareholder value; however, what troubled him was that (i) it was "obviously shown that this board was not informed about the potency of this clause … [t]he CEO was not aware of it … [and] it's not even clear the banker was aware of it"[13] and (ii) failing to disclose the existence of these provisions in the proxy statement created "a false impression that any of the folks who signed the standstill could have made a superior proposal."[14] Chancellor Strine enjoined the shareholder vote pending disclosure of the use of the DADW standstill provisions.[15]

DADW Standstill Provisions and the Auction Process

The Delaware courts have made clear that "there is no single blueprint that a board must follow to fulfill its duties" in selling a company.[16] Nonetheless, certain patterns have emerged. An auction process often begins with an initial round in which a limited number of potential bidders are invited to provide indications of interest. This initial round is followed by successive rounds, where a relatively small number of bidders are allowed to perform due diligence and are invited to make more definitive offers. The field is narrowed by eliminating low bidders and bidders that are viewed as unlikely to be able to complete a transaction. At the end of the process, the remaining bidders are asked to submit "best and final" offers. This last stage is similar to a first price, sealed-bid auction, in that each bidder does not know what the other bidders are offering, and the company is sold to the highest bidder at the price offered by that bidder. In practice, the "best and final" round is often followed by further negotiations and one or more losing bidders may be offered an opportunity to outbid the presumptive winner from the "best and final" round. The result is that a real-world auction may include features of both a first price, sealed-bid auction and an open outcry auction.[17]

Despite (or perhaps because of) the assertion by Delaware courts that there is no single blueprint for selling a company, the vast majority of public company merger agreements include "fiduciary out" provisions, allowing the board of directors to inform itself regarding potential superior proposals, and to terminate the merger agreement to accept a superior proposal, subject to payment of a reasonable termination fee.[18] As a practical matter, this means that the last step in almost every sale process (following announcement of an executed merger agreement) is an open outcry auction in which the announced acquirer serves as a stalking horse. From the acquirer's perspective, this is problematic because it creates uncertainty as to whether it will be able to complete the acquisition at the agreed price. From the target's perspective, this is problematic because it undermines the best and final sealed-bid auction that the target thought it ran prior to executing the merger agreement. One purported advantage of the sealed-bid auction is that uncertainty regarding the competing bids discourages a bidder from holding back its best price, thereby increasing the likelihood that the final price will represent the best price of the bidder who places the highest value on the company. In contrast, in an open outcry auction, the company would be sold at a price only slightly higher than that of the bidder who places the second-highest value on the company. If there is a large gap between the values placed on the company by the top two bidders, the open outcry auction can leave significant value on the table. Because the fiduciary out effectively converts almost every auction for a public company into an open outcry auction, the effectiveness of the target company's "best and final" sealed-bid process is undermined. If a bidder believes that its best price may be significantly higher than the second-highest bid, it might be inclined to hold something back, knowing that if it bids too low and loses it will have another chance to submit a topping bid after the merger agreement is signed (subject, of course, to payment of a termination fee to the stalking horse bidder).

In response, some target companies and acquirers have subverted the open outcry auction that typically follows the announcement of a merger agreement by excluding the most likely bidders—those that participated in the initial auction. This has been accomplished by requiring (i) prospective bidders to agree to DADW standstill provisions that survive the execution of a merger agreement with a third party and (ii) including a provision in the merger agreement prohibiting the target from waiving the standstill.[19]

Whether DADW standstill provisions that remain in place after the auction process encourage auction participants to put forward their best bid during the auction process is a subject of debate. The Delaware courts have abstained from taking a position on the value-maximizing role of DADW standstill provisions, stating only that it is possible these provisions play a value-maximizing role.[20] While we concede that, as a theoretical matter, DADW standstill provisions that remain in place after the signing of a definitive agreement can play a value-maximizing role by encouraging bidders to make their "best and final" offers in the auction (because they will be unable to make a topping bid following the conclusion of the auction),[21] we reject that notion as a practical matter. Our view stems from our consistent experience that auctions in the public company target context are not conducted as pure "sealed-bid" auctions, in which the bidders do not have some sense of the competing bids and the "final" bids remain final.[22] Rather, a target's investment bankers will often keep competing bidders apprised of where the top bids are (at least approximately) in an effort to get them to increase their respective bids above the then-current highest bid.[23] Furthermore, because the vast majority of merger agreements include a fiduciary out, and the enforceability of DADW standstill provisions is uncertain, bidders understand that, in most instances, a merger agreement will not necessarily end the auction. We therefore find predictions that requiring DADW standstill provisions to fall away at the signing of a definitive agreement "may affect the way sophisticated parties engage in auctions, and even their willingness to do so"[24] to be unduly alarmist.

Some may disagree with our premise on the grounds that, even if the bankers do provide such information, because there is no way for a bidder to verify the information, these bankers' updates have little effect on what a bidder will offer in response to such "coaching." While we acknowledge that there is no way to verify the information in real time, we disagree that this dynamic does not have a significant impact on the sale process because bidders will know, after the fact, from the proxy statement whether the banker was truthful (about the high bid they need to beat).[25] As these auctions are not single iteration games for the players involved, a banker who misleads bidders with regard to the amount of another bid would presumably suffer reputational harm and thus inhibit his or her ability successfully to conduct auctions in the future.

The Way Forward

Because target companies may provide confidential information to a relatively large number of prospective bidders, standstills serve the important purpose of preventing these potential bidders from using the confidential information to launch a hostile tender offer or proxy contest, in the event the target chooses not to sell itself.[26] The need for DADW standstill provisions, however, is reduced once the company has determined to sell itself and entered into a definitive merger agreement. As discussed above, we believe in most cases the utility of DADW standstill provisions as a gavel in the auction process is limited. Accordingly, it makes sense to permit potential bidders to make private offers, or to request waivers, once the target has entered into a merger agreement.

Drafting the private offer portions of the DADW standstill provisions to terminate automatically upon signing a definitive merger agreement affords parties the benefit of using them during the auction process (*i.e.*, to conduct the auction in a controlled way) while, at the same time, avoiding the problematic interplay, as illustrated in *Celera*, with the non-solicitation and enforcement-of-standstill provisions of the merger agreement. Such automatic termination also ensures that a target board has the opportunity to comply with its fiduciary obligation to remain adequately informed. This approach has the added benefit of making it unnecessary for the target to attempt to resist the covenant in the merger agreement to enforce the DADW standstill provisions (something which can be difficult) since the private offer portions of the DADW standstill provisions will have been drafted to terminate automatically upon the execution of a definitive agreement.[27] The result is that a public company auction is similar to a Section 363 bankruptcy sale. The acquirer that signs a merger agreement is essentially a stalking horse bidder. The stalking horse has the benefit of reasonable deal protections, such as matching rights and a break-up fee, but otherwise recognizes that the deal is open to being topped by an interloper.

We note that other commentators have advocated that more restrictive DADW standstill provisions should "be paired with a minimal fiduciary out that would allow bidders bound by the standstill to request a waiver if certain clearly articulated new information were to come to light."[28] We disagree with this prescription because the fact that a bidder wishes to submit a topping bid is, in and of itself, new information that the board, in keeping with its fiduciary duty to remain informed on an ongoing basis, needs to keep itself apprised of, regardless of the underlying reasons for any such bid. For example, a potential bidder might change its own strategy (perhaps in response to a competitor announcing a merger agreement with the target) in a way that makes the target more attractive than it was at the time of the auction, even in the absence of new information about the target. If this were the case, presumably the target board would have a duty to inform itself.

We recommend that, as a minimum, the DADW standstill provisions should fall away upon execution of a definitive merger agreement so as to allow another bidder to go privately to the target board with an offer. An alternative would be to allow public, as well as private, offers. The benefit of forcing bidders to go privately to the target's board with a proposal is that it allows the board to control public disclosure of the offer. This may be particularly important if an offer appears attractive on the surface because it is at a higher price than the merger agreement, but is otherwise unattractive to the board (*e.g.*, because it raises regulatory issues such that it is unlikely to be consummated). While in many cases any such private offer should be disclosed by the company in the proxy statement (or a supplement thereto), or other disclosure document, practitioners should weigh the benefits of requiring the bidder to approach the company privately against any potential benefits to the stockholders from allowing a bidder to tell its side of the story.[29]

A target company that seeks to bind potential acquirers to DADW standstills that survive a merger agreement faces a number of risks. First, the target company may create an uneven playing field in any bidding that occurs after the merger agreement is signed. Some bidders might ignore the provision, believing that it is unenforceable or that any breach of the DADW standstill will not result in damages recoverable by the target. Others might honor the provision to avoid litigation or because they have a policy of honoring their agreements. As a result, the bidder with the highest value might not participate in any post-signing bidding activity. Second, a court might scrutinize the process leading to the company's decision to require such standstills, including the board's involvement (or lack thereof), and might find the process wanting as in *Ancestry*. Finally, a court might find that the combination of the DADW standstills and the non-solicitation covenant in the merger agreement amount to a breach of fiduciary duty as suggested in *Celera* and *Genomics*. All these risks are eliminated if the original standstill agreements permit bidders to make offers and request waivers after a merger agreement is signed.[30] Accordingly, we think that well-advised targets generally will not seek to prevent parties that participate in the pre-signing auction from making topping bids after a merger agreement is signed.

NOTES

1. *See In re Complete Genomics Shareholder Litigation* (C.A. 7888-VCL, Del. Ch. November 27, 2012) at 14. *See also Phelps Dodge Corporation v. Cyprus Amax* (C.A. No. 17427, Del Ch. 1999) stating that no-talk clauses "are troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party" (*Phelps* at 34) and finding that for a board to completely foreclose the opportunity to communicate with third parties "is the legal equivalent of willful blindness, a blindness that may constitute a breach of a board's duty of care; that is, the duty to take care to be informed of all material information reasonably available." *Id*. at 35.
2. *See also In re The Topps Company Shareholder Litigation*, 926 A.2d 58, 62 (Del. Ch. 2007), stating that "a standstill can be used by a target improperly to favor one bidder over another, not for reasons consistent with stockholder interest …" and enjoining the shareholder vote until after the Topps board granted Upper Deck a waiver of its standstill. *See also In re RehabCare Group Inc. Shareholder Litigation* (C.A. No. 6197-VCL, Del. Ch. September 8, 2011) at 46, stating that the "agree not to ask" portion of the standstill "optically looks bad when you're reviewing deal facts" and expressing doubt that such a provision "is ever going to hold up if it's actually litigated, particularly after Topps … [and further] that it doesn't give you [the target board] any ultimate benefit because you know the person can get a Topps ruling making you let them ask, at a minimum, [for a waiver of the standstill provision] or ask in a back channel way." *See also In re Bioclinica, Inc. Shareholder Litigation* (C.A. No. 8272-VCG, Del. Ch. February 25, 2012), in which the court seems to accept the premise that a target company cannot exclude parties that sign NDAs from bidding after a merger agreement is signed, stating "[i]f the facts underlying this paragraph [from the Plaintiff's Reply Brief] were true, the Plaintiffs may have stated a colorable claim justifying expedition. A deal-protection tool that could both (1) relegate a bidder to making a tender offer, without approaching the board of directors, and then (2) trigger the onerous provisions of a poison pill upon the mere announcement of such a tender offer could indeed preclude a bid from any party that had signed such an NDA."
3. *Genomics* at 11-12.
4. *Id*. at 12.

5. See Order Granting In Part Plaintiffs' Motion For a Preliminary Injunction (Del. Ch. December 4, 2012).
6. *In re Celera Corporation Shareholder Litigation* (C.A. No. 6304-VCP, Del. Ch. 2012).
7. Celera at 53.
8. *Id*. at 53-54.
9. *Id*. Vice Chancellor Parsons also, for the sake of clarification, stated that he was not going so far as finding that "provisions expressly barring a restricted party from seeking a waiver of a standstill necessarily are unenforceable." *Id*. at 54.
10. *See In re Ancestry* (C.A. No. 7988-CS, December 17, 2012) at 224-225.
11. Chancellor Strine also took pains to point out that *Ancestry* was a bench ruling, stating that "[b]ench rulings are limited rulings. They're time-pressured ones … and because they're time pressured, they shouldn't make broad law... ." *Id*. at 222.
12. *Id.* at 224.
13. *Id.* at 227.
14. *Id.* at 228.
15. The Ancestry board waived the "don't ask" portion of the DADW on December 11, 2012 following the filing of the litigation challenging the provision. Chancellor Strine stated that, if these provisions are to be used as a gavel, "then the electorate should know that … they should understand that there is a segment of the market where that segment cannot take advantage of [the ability to make a superior proposal]" (*Ancestry* at 230). Chancellor Strine also indicated that he would have sent a letter to all the auction bidders the "nanosecond" after signing the definitive agreement waiving the DADW provision to make "clear to all of them [the other bidders] if they wish to ask for a waiver in order to make a superior proposal that they are legally allowed to do so (*Id*. at 231). Of course, that assumes that the merger agreement signed the nanosecond before doesn't prohibit such a waiver, as many now do. *See* "The Way Forward" in the text, *infra*. Since, in *Ancestry*, the DADW had already been waived by the board, Chancellor Strine's ruling was limited to disclosure surrounding the use of the DADW provision in the process. We believe therefore that observers who conclude that "[t]he Ancestry ruling reaffirms [that] … [c]ontracts, including standstills, will be respected and enforced as written" may take this ruling further than they should. *See, e.g.,* Trevor S. Norwitz, Igor Kirman and William Savitt, *"'Don't Ask, Don't Waive Standstills' Revisited (Rapidly),"* Wachtell, Lipton, Rosen & Katz, December 28, 2012. It is not at all certain that a standstill provision would be enforced as written if the court concludes that it is being used improperly (as in *Topps*) or without careful consideration by the Board (as in *Ancestry*).
16. *See Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989).
17. *See* Guhan Subramanian, *Deal Making: The New Strategy of Negotiauctions* (W.W. Norton & Company, Inc., 2010), Chapter 4 "Choosing the Right Kind of Auction."
18. *See, e.g., In re OPENLANE, Inc. Shareholders Litigation* (C.A. No. 6849-VCN) (Del. Ch. 2011) at footnote 53, stating that "*Omnicare* may be read to say that there must be a fiduciary out in every merger agreement."
19. *See, e.g.*, Section 5.3 of the Agreement and Plan of Merger among BGI-Shenzen, Beta Acquisition Corporation and Complete Genomics, Inc., dated as of September 15, 2012, stating, in relevant part, that the Company (including its subsidiaries and representatives) shall not "waive, terminate, modify, fail to enforce or release any Person other than Parent or the Purchaser from any provision of or grant any permission, waiver or request under any 'standstill,' confidentiality or similar agreement or obligation… ." The court in *Genomics* seemed to reject this tactic when it enjoined the "don't ask" portion of the DADW provision insofar as it purported to forbid one of the bidders in the auction from making a non-public request for a waiver of its standstill. See our discussion of *In re Genomics* in the text, *supra*. *But cf. Ancestry*, in which Chancellor Strine found that DADW provisions were not *per se* invalid and that such provisions could be used to encourage the fullest possible bids by auction participants, but stating that their use should be monitored by the board of directors and disclosed in the proxy statement. *See* our discussion of *In re Ancestry* in the text, *supra*.
20. *See, e.g., Ancestry*, in which Chancellor Strine, in discussing DADW standstill provisions, stated "I'm not prepared to rule…that they [DADW standstill provisions] can't be used for value-maximizing purposes. But the value-maximizing purpose has to be to allow the seller as a well-motivated seller to use it as a gavel, to impress upon the people that it had brought into the process the fact that the process is meaningful." *Ancestry* at 225.
21. For purposes of this article, we assume that the DADW provision has a "directly or indirectly" clause, such that the provision prohibits a potential loser in the auction from telling the target board, "But for the DADW, we would request a waiver of the standstill to permit us to offer you $X per share… ." We also ignore the question of whether damages are

recoverable in the event of a breach of the DADW standstill.

22. For a discussion of various types of auctions, including, among others, "sealed-bid auctions," see Christina M. Sautter, "*Auction Theory and Standstills: Dealing with Friends and Foes in a Sale of Corporate Control*" DRAFT, January 26, 2012, at 20-26 (Electronic copy available at: http://ssrn.com/abstract=2207693).

23. How often have deal practitioners heard from the target's banker, "you need to bid $X in order to stay in the auction"?

24. Trevor S. Norwitz, Igor Kirman and William Savitt, "*'Don't Ask, Don't Waive Standstills' and the Auction Problem,*" Wachtell, Lipton, Rosen & Katz, November 30, 2012.

25. *See, e.g.*, Presidential Life Corporation (Schedule 14A at 35-36) (November 15, 2012) (in which, after the Presidential Life board subcommittee concluded that Party A's proposal was superior to that of Athene, "[t]he Subcommittee decided to inform Athene that the Company had received a proposal superior to Athene's most recent proposal and that the Subcommittee may be in a position to recommend to Presidential's board of directors execution of that superior proposal shortly. Sandler O'Neill asked Athene to withdraw certain requested changes to the merger agreement and increase its offer price per share…").

26. Standstills are also important to the extent they prohibit a losing bidder from publicly challenging an announced merger agreement without making a new bid, which is why we propose that certain portions of the standstill (*e.g.*, those prohibiting the losing bidders from making public communications, waging proxy contests and effecting share accumulations) should continue following execution of a merger agreement.

27. Once the winning bidder has been selected by the target, it is often difficult for a target to resist the winning bidder's request for a covenant in the merger agreement prohibiting the target from waiving any standstill agreement.

28. *See* Sautter DRAFT at 74. Sautter advocates that, in such a case, a higher termination fee should apply.

29. The Delaware courts have arguably presented inconsistent views on the importance of allowing a topping bidder to go public with its offer. *See e.g.*, *Topps*, in which then Vice Chancellor Strine notes that "Topps went public with statements disparaging Upper Deck's bid and its seriousness but continues to use the Standstill to prevent Upper Deck from telling its own side of the story. The Topps board seeks to have the Topps stockholders accept Eisner's bid without hearing the full story. That is not a proper use of a standstill by a fiduciary given the circumstances here. Rather, it threatens the Topps stockholders with making an important decision on an uninformed basis…" (*Topps* at 64-65). *But cf. Genomics*, suggesting that allowing a bidder to privately make an offer is sufficient for the board to meet its obligations to remain informed on an ongoing basis (*Genomics* at 11-12).
In addition to merely telling its side of the story, a bidder could also be allowed to take its offer directly to the shareholders by launching a hostile tender offer. We note that waiving the DADW standstill provisions in such a way as to allow a bidder to launch a hostile tender offer would not preclude the target board from subsequently adopting defensive measures in response to a tender offer. *See e.g., Topps,* in which the court noted that "Upper Deck is not even asking for some sort of prior restraint preventing the Topps board from implementing a rights plan in the event of a tender offer." *Topps* at 64. The court, however, further acknowledges that Upper Deck had indicated that the adoption of a rights plan in the face of a tender offer would begin a new round of litigation between the parties. Because the adoption of defensive measures in the face of a tender offer would be reasonably likely to lead to litigation between the bidder launching the tender offer and the target, whether to waive the standstill to such an extent should also be evaluated on a case by case basis by the target board and its advisors.

30. This approach also ensures consistent treatment of all bidders.

The Uncertain Relationship Between Fiduciary Waivers & the Implied Covenant of Good Faith in Delaware Alternative Entity Law

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Delaware alternative entity law—*i.e.*, the Revised Uniform Limited Partnership Act ("LP Act")[1] and the Limited Liability Company Act (the "LLC Act")[2]—explicitly intend "to give maximum effect to the principle of freedom of contract" by allowing limited partnership ("LP") and limited liability company ("LLC") agreements to expand, restrict, or eliminate duties "(including fiduciary duties)" that a person might owe to an LP or LLC.[3] The only condition placed on this otherwise broad endorsement of private ordering is that alternative entity agreements "may not eliminate the implied contractual covenant of good faith and fair dealing."[4] Consistent with this statutory authority, numerous LP and LLC agreements expressly disclaim fiduciary duties. As a result, these agreements limit the duties of general partners and managers to complying with the agreements' express and implied terms, seemingly eschewing the more searching *Revlon* or entire fairness standards of review applicable to corporate directors' conduct in approving mergers or self-interested transactions, respectively.

The importance of this contractual freedom is difficult to overstate. For example, in an empirical study of publicly traded LPs[5] and LLCs in existence in 2011, only one was organized under the laws of a jurisdiction other than Delaware.[6] Furthermore, just shy of 90% of those publicly traded Delaware alternative entities "either totally waive the fiduciary duties of managers or eliminate liability arising from the breach of fiduciary duties."[7] A reasonable inference from this data is that the very ability to modify, or at least to exculpate from monetary liability for breaching, the traditional duties of care and loyalty afforded by the LP and LLC Acts is what attracts business planners to Delaware alternative entities in the first instance.

The Problem

Nevertheless, a number of class actions challenging mergers and other conflict transactions involving alternative entities recently have been brought in the Delaware Court of Chancery due to an apparent conflict in Delaware's implied covenant doctrine.[8] One line of implied covenant cases, best represented by the Delaware Supreme Court's majority decision in *Nemec v. Shrader*,[9] characterizes the implied covenant as a mechanism to "infer[] contractual terms to handle developments or contractual gaps that. . .neither party anticipated,"[10] but that therefore "cannot be used to circumvent the parties' bargain, or to create a free-floating duty. . .unattached to the underlying" contract.[11] A second line of cases, best represented by the Delaware Supreme Court's decisions in *Dunlap v. State Farm Fire & Casualty Co.*[12] and *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity, II, L.P.*,[13] however, characterizes the implied covenant in broader terms, as an "obligation to preserve the *spirit* of the bargain rather than the letter."[14] "[G]overned *solely* by 'issues of compelling fairness,'"[15] the implied covenant—according to this second line of cases—"requires more than just literal compliance" with the express contract and positive law, but also "act[ing] in a way that honors the [other party]'s reasonable expectations."[16] Among other things, this expansive characterization of the implied covenant has been interpreted in an unbroken chain of cases to require a party exercising contractually conferred discretionary rights "to exercise that discretion in a *reasonable* manner. Reasonableness is a question of fact to be determined by the finder of fact."[17]

This broader formulation of the implied covenant appears to invite equitable review of a party's actions, express contract terms notwithstanding. Take, for example, an LP agreement that expressly (1) waives fiduciary duties and (2) permits the general partner to make (or decline to make) all decisions in its sole discretion in managing the business, limited only by its subjective belief that its decisions are in the best interest of the partnership. Under the first, narrow line of implied covenant cases, there is no gap for the implied covenant to fill. The parties affirmatively chose to endow the general partner with discretionary authority to act, and they delineated the scope of that discretion by a subjective belief condition. So long as the general partner subjectively believes it is acting in the company's best interest, the implied covenant cannot override the general partner's express contractual right to exercise discretion. If, however, the general partner acts with a contrary subjective belief, then it has breached an express provision of the contract. In either case, the implied covenant is irrelevant.

Under the second, broad line of implied covenant cases, by contrast, there is inescapable room for the implied covenant. Because the waiver of fiduciary duties effectively makes every act discretionary, every business decision (*i.e.*, each exercise of contractually-conferred discretion) is susceptible to challenge as having been unreasonable. In other words, taking full advantage of the ability to contract out of fiduciary duties ironically seems to result in a "loop" whereby the implied covenant imposes on the general partner a standard of conduct that the contracting parties plainly intended to avoid.[18] And even more ironic is that this seeming result follows the parties' invocation of a statutory scheme explicitly intended to encourage private ordering and freedom of contract.

The Fix (?)

We say this second line of cases only "seems" to subject general partners and managers' business decisions to a reasonableness standard because the Court of Chancery has been clear that "[t]he implied covenant is not a substitute for fiduciary duty analysis."[19] Nevertheless, reasonableness challenges of this sort are "tempting" to plaintiffs[20] and, while the Delaware courts have expressed antagonism to grafting purely equitable principles onto the implied covenant,[21] the Court of Chancery has not yet settled on a singular, logical framework that cogently disposes of reasonableness challenges in the alternative entity context, nor has the Delaware Supreme Court yet affirmed any of the various frameworks that the Court of Chancery has attempted thus far. There are at least two strains of reasoning that the Court of Chancery has employed in recent months to ensure this doctrinal ambiguity does not undermine clear contractual provisions intended to preclude searching equitable challenges to alternative entity managers' conduct.[22]

(1) Strict Interpretation of the "Gap Filler" Line of Cases

In *Gerber 2012*, Vice Chancellor Noble adopted a strict interpretation of *Nemec*'s directive that the implied covenant cannot override an express contractual right. Among other things, that case challenged a sale by a master limited partnership of one of its subsidiaries to an affiliate of the general partner for allegedly $1 billion less than the subsidiary's fair value, *i.e.*, a classic self-dealing transaction. Although the limited partnership agreement required that any transactions with affiliates be "fair and reasonable," the agreement also provided for, and the general partner followed, a "Special Approval" process: if the independent directors of the general partner approved the self-interested transaction, then it would be deemed "fair and reasonable." Because the use of that Special Approval process was discretionary, however, the Court held that the general partner "had a duty, under the implied covenant, to act in good faith if it took advantage of the Special Approval process."[23]

Nevertheless, the partnership agreement also contained a provision that any action in reliance on an expert's opinion "shall be conclusively presumed" to have been done in good faith, and the general partner had received a fairness opinion from Morgan Stanley that the consideration received in the transaction was fair from a financial point of view to the partnership and its limited partners. As the Court wrote,

> **The drafters of the LPA [*i.e.*, the limited partnership agreement] foresaw that claims against [the general partner] asserting a failure to act in good faith could arise in a number of circumstances. The drafters decided that none of those claims could be asserted if [the general partner] acted in reliance upon the opinion of an expert. Under the LPA, [the general partner] has an "express contractual right" to rely upon the opinion of an expert and thereby be conclusively presumed to have acted in good faith. The Court may not "infer language that contradicts a clear exercise" of that right. Although the well-pled facts of the Complaint may suggest that [the general partner] breached the implied covenant, that claim is precluded by Section 7.10(b) of the LPA.[24]**

In a footnote, the Court added:

> **This conclusion raises the question: how can a section of the LPA preclude a claim for breach of the implied covenant when 6 *Del. C.* § 17-1101(d) provides that a "partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing?" The answer is that although the covenant of good faith and fair dealing may sound like some grandiose principle, it is a gap-filler. . . .**
>
> **[A]s the Supreme Court has explained [in *Nemec*], if a contract has no gaps, then the implied covenant is not applicable to that contract. A limited partnership agreement may not validly state that "the implied covenant is not part of this agreement," but if a limited partnership agreement simply has no gaps, then the implied covenant will never apply to that agreement.**
>
> **The LPA provides that if [the general partner] follows a specific procedure, then any gaps that may appear in the LPA will be filled with a conclusive presumption of good faith. When [the general partner] caused [the partnership] to undertake the 2009 Sale, it followed that specific procedure in deciding whether to take advantage of the Special Approval process. Thus, any possible gap that [the plaintiff] might be able to find in the use of the Special Approval process will be filled with a conclusive presumption of good faith. There can be no claim that [the general partner] breached the implied covenant.[25]**

While the Court's explanatory footnote reflects a faithful interpretation of *Nemec*, it also—as the Court itself acknowledged—"take[s] the reader *and* the writer to the outer reaches of conduct allowable under 6 *Del. C.* § 17-1101."[26] Moreover, the distinction that it draws between the impermissible term "the implied covenant is not part of this agreement" and the supposedly permissible term "if X, then no claims predicated on bad faith may be brought" ultimately may be untenable. Consider, for example, the following hypothetical term: "If the Manager is validly elected by the Members, then it is entitled to a conclusive presumption of good faith for every action it takes until the next Manager elections." Such a provision also purports to fill in all gaps, but nevertheless reduces to an unlimited conferral of discretion in managing the affairs of the business. Perhaps the salient distinction is the degree of specificity required before a conclusive presumption is possible: in *Gerber 2012*, the general partner had to follow a prescribed process of submitting the transaction to a committee of independent directors, the qualifications for whom also were prescribed by the LPA, for their Special Approval before a conclusive presumption would attach; in the hypothetical provision just posited, the process for obtaining the presumption is entirely open-ended. Of course, if the degree of specificity is the salient detail, then the courts nevertheless likely will find themselves in a lengthy sequence of litigation seeking to clarify exactly where the line of "specific enough" is drawn.

(2) Revaluation of the "Reasonableness" Lines of Cases

A second line of cases has not relied on such a strict reading of *Nemec*. Instead, these cases have attempted to reconcile the reasonableness requirement with *Nemec* by using the general scheme of the particular contract as the gauge against which the reasonableness of discretionary determinations are to be evaluated in any given case. For example, the facts of *Encore Energy* are similar to those of *Gerber 2012*. In *Encore Energy*, the general partner approved a merger[27] of the partnership into the general partner's controlling shareholder after seeking and obtaining Special Approval from an independent committee, who relied on an investment bank's fairness opinion that the consideration was fair to the unaffiliated unitholders. The plaintiffs nevertheless challenged the good faith of the transaction, alleging that the independent committee's agreement to a premium of less than 1% of the units' preannouncement trading price reflected a lack of meaningful, good faith negotiations with the controller.

After concluding that the Special Approval process fulfilled the express contract provisions, Vice Chancellor Parsons turned to the plaintiffs' claim that the general partner did not exercise its discretion to use Special Approval in good faith. First, the Court emphasized reasoning from *Dunlap*, the leading "reasonableness" case, that the implied covenant does not impose a "free-floating duty." Rather, the Court relied on Vice Chancellor Laster's then-recent *ASB Allegiance* opinion that:

> **"[f]air dealing" is not akin to the fair process component of entire fairness, *i.e.*, whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care. . . .It is rather a commitment to deal "fairly" in the sense of consistently with the terms of the parties' agreement and its purpose. Likewise "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.[28]**

The *Encore Energy* Court then held that Delaware's implied covenant doctrine "disclaim[s]" a duty of objective fairness, and instead required the plaintiffs to "identify how the Conflicts Committee's allegedly feckless negotiations 'frustrate[d] the fruits of the bargain that the [parties] reasonably expected'" at the time of contracting.[29] Having determined to evaluate the "reasonableness" of the general partner's actions against the general contract scheme, the Court had little difficulty concluding that the limited partnership agreement was "inimical to *requiring* that a transaction receiving Special Approval be objectively fair and reasonable."[30] Indeed, the Court found that the limited partnership agreement "plainly intended to give the General Partner and its Affiliates maximum flexibility. Under these circumstances, an inference that the concededly modest protections afforded to Plaintiffs by the LPA frustrated their legitimate expectations would be unreasonable even on a motion to dismiss."[31]Accordingly, the Court dismissed the implied covenant claim.[32]

Encore Energy's reasoning is susceptible to some doubt, in that it made no attempt to address the holding of *Desert Equities* that, not only must contractual discretion be exercised reasonably, but "[r]easonableness is a question of fact."[33] Ordinarily, a court cannot decide questions of fact on a motion to dismiss, which the *Encore Energy* Court implicitly did in concluding that the general partner's use of Special Approval to immunize the merger was reasonable. Thus, while *Encore Energy* arguably is a sound attempt to reconcile Delaware's implied covenant doctrine in a manner consistent with the LP and LLC Acts, it does not resolve the continuing conflict in Delaware's implied covenant doctrine.

The Implications

The import for business planners of this concededly nuanced doctrinal landscape is that alternative entities—even those that expressly disclaim fiduciary duties—are susceptible to greater litigation risk than may be apparent. To be clear, the Court of Chancery appears committed to honoring express waivers of fiduciary duties in the context of deal litigation involving alternative entities, and we do not believe there is a significant risk of plaintiffs prevailing under any of the "seeming" theories we discussed above. That is, it is not the risk of liability that is underappreciated.

Rather, the risk is that Delaware's implied covenant doctrine "seems" to open a backdoor to fiduciary review that, as the Court of Chancery has described it, is "tempting" to plaintiffs and plaintiffs' firms. Furthermore, until that backdoor definitively is shut, unaffiliated equity holders have at least a colorable legal theory on which to initiate litigation against alternative entities and those who manage them. It is, thus, this legitimate risk of being sued—and all of the attendant legal fees, distraction, and uncertainty litigation causes—that is underappreciated by business planners and may undermine a supposed advantage of the alternative entity form in the first instance. This is especially true for publicly traded alternative entities, which often operate in the oil and gas industry, because of plaintiffs' firms incentive to pursue representative actions on behalf of large classes of dispersed equity holders, but the legal uncertainty applies to alternative entities generally regardless of size, industry, or capital structure.

NOTES

1. 6 *Del. C.* §§ 17-101 to 17-1111 [hereinafter LP Act].
2. 6 *Del. C.* §§ 18-101 to 18-1109 [hereinafter LLC Act].
3. LP Act § 17-1101(c), (d); LLC Act § 18-1101(b), (c).
4. LP Act § 17-1101(d); LLC Act § 18-1101(c).
5. Publicly traded LPs often are renamed master limited partnerships, or MLPs. This change in appellation, however, does not affect the legal framework undergirding the entities' organization and internal affairs. Rather, in Delaware, the LP Act continues to control.
6. Mohsen Manesh, Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs, 37 J. Corp. L. 555, 598 n.236 (2012).
7. *Id.* at 557.
8. *See, e.g., Gerber v. EPE Hldgs.*, LLC,2013 WL 209658 (Del. Ch. Jan. 18, 2013) [hereinafter Gerber 2013]; *In re Encore Energy P'rs LP Unitholder Litig.*, 2012 WL 3792997 (Del. Ch. Aug. 31, 2012); *In re K-Sea Transp. P'rs L.P. Unitholder Litig.*, 2012 WL 1142351 (Del. Ch. Apr. 4, 2012*); Gerber v. Enter. Prods. Hldgs.*, LLC, 2012 WL 34442 (Del. Ch. Jan. 6, 2012) [hereinafter Gerber 2012]; *Brinckerhoff v. Enbridge Energy Co., Inc.*, 2011 WL 4599654 (Del. Ch. Sept. 30, 2011) [hereinafter Enbridge Energy]; *In re Atlas Energy Res., LLC*, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010); *Lonergan v. EPE Hldgs., LLC*, 5 A.3d 1008 (Del. Ch. 2010); *Brinckerhoff v. Tex. E. Prods. Pipeline Co., LLC*, 986 A.2d 370 (Del. Ch. 2010) [hereinafter TEPPCo]. It should be noted that litigation implicating the implied covenant in the alternative entity context extends beyond deal litigation. For example, the relatively recent case of *Policemen's Annuity & Benefit Fund of Chi. v. DV Realty Advisors LLC*, 2012 WL 3548206 (Del. Ch. Aug. 6, 2012), concerned whether the limited partners validly removed the general partner of a Delaware LP, a question which turned on whether contractually conferred discretion had been exercised reasonably under the implied covenant, see infra note 17 and accompanying text.
9. The mere fact that *Nemec* was decided by a slim 3-2 majority itself is noteworthy, in that only rarely does the Delaware Supreme Court decide a case other than unanimously.
10. *Nemec v. Shrader*, 991 A.2d 1120, 1125 (Del. 2010).
11. *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 441 (Del. 2005) (internal quotation marks omitted).
12. 878 A.2d 434, 441 (Del. 2005).
13. 624 A.2d 1199 (Del. 1993).
14. *Dunlap*, 878 A.2d at 444. For the sake of clarity, *Dunlap* did not concern the interpretation of an alternative entity operating agreement, or even of a merger or other complex transaction agreement, but of an individual motor insurance policy. Nevertheless, because the LP and LLC Acts intend to treat operating agreements as ordinary contracts, the type of contract involved does not mean that *Dunlap* is irrelevant to the interpretation of alternative entity agreements. In any event, *Desert Equities* did involve the interpretation of an LP agreement.
15. *Id.* at 442 (emphasis added) (quoting *Cincinnati SMSA Ltd. P'shp. v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992-93 (Del. 1998)).

16. *Id.* at 444.

17. *Desert Equities,* 624 A.2d at 1206; *see also Encore Energy*, 2012 WL 3792997, at *12 ("when a contract confers discretionary rights on a party, the implied covenant requires that party to exercise its discretion *reasonably*" (emphasis added) (citing *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 441 (Del. Ch. July 9, 2012)); *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 146-47 (Del. Ch. 2009) ("When a contract confers discretion on one party, the implied covenant requires that the discretion be used reasonably and in good faith.").

18. Furthermore, Delaware courts often use the term "reasonableness review" interchangeably with the enhanced judicial scrutiny prescribed by *Revlon* and *Unocal* for certain extraordinary corporate decisions, meaning the implied covenant's reasonableness standard for even ordinary business decisions arguably is more onerous than that faced by corporate directors under traditional fiduciary duties. *See, e.g., In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1000 (Del. Ch. 2005) ("[T]he Supreme Court held that courts would subject directors subject to *Revlon* duties to a heightened standard of reasonableness review, rather than the laxer standard of rationality review applicable under the business judgment rule."); *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 439-40 (Del. Ch. 2002) (noting defensive measures are "subject to a heightened form of reasonableness review under the so-called *Unocal* standard").

19. *Lonergan*, 5 A.3d at 1017; *accord Gerber 2013*, 2013 WL 209658, at *11 (citing *Lonergan*); *Encore Energy*, 2012 WL 3792997, at *12 (citing *Lonergan*).

20. *Gerber 2013*, 2013 WL 209658, at *11.

21. *See, e.g., Nemec*, 991 A.2d at 1128 ("[A] post contracting equitable amendment that shifts economic benefits. . .would vitiate the limited reach of the concept of the implied duty of good faith and fair dealing.").

22. It is worth emphasizing that these approaches do not portend management bias on the part of the Delaware Court of Chancery. As the Court noted in *Encore Energy*, for example: "The near absence under the [limited partnership agreement] of any duties whatsoever to Encore's public equity holders presumably would discourage risk averse investors unwilling to take a leap of faith from investing their money in an enterprise controlled by the General Partner and its Affiliates. But, the right to enter into good and bad contracts makes the implied covenant an ersatz substitute for the warning 'caveat emptor.' Investors apprehensive about the risks inherent in waiving the fiduciary duties of those with whom they entrust their investments may be well advised to avoid master limited partnerships like Encore. Having decided to take a leap of faith and to reach for the kind of returns a master limited partnership investment might yield, however, Plaintiffs cannot reintroduce fiduciary review through the backdoor of the implied covenant." *Encore Energy*, 2012 WL 3792997, at *13 (internal quotation marks and footnotes omitted). Similarly, in *Gerber 2012*, the Court observed that, "[i]f the protection provided by Delaware law is scant, then the LP units of these partnerships might trade at a discount" and, in any event, the LP Act's express authority to waive fiduciary duties reflects a legislative determination "that this Court has only a limited role in protecting the investors of publicly traded limited partnerships that take full advantage of 6 *Del. C.* § 17-1101(d), and that is a role this Court must accept." *Gerber 2012*, 2012 WL 34442, at *10 n.42.

23. *Gerber 2012*, 2012 WL 34442, at *11. Shortly after Vice Chancellor Noble issued *Gerber 2012*, Vice Chancellor Parsons adopted this reasoning in *In re K-Sea*, 2012 WL 1142351, at *9-10. Both cases are pending appeal to the Delaware Supreme Court.

24. *Gerber 2012*, 2012 WL 34442, at *13.

25. *Id.* at *13 n.58.

26. *Id.* at *13.

27. Although the merger also required approval by the limited partners, the acquirer already held a significant number of limited partnership units, which it insisted on voting in favor of the then-pending merger. In other words, the unitholder vote provided no meaningful protection to the unaffiliated unitholders in the circumstances of this case.

28. *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 441 (Del. Ch. July 9, 2012).

29. *Encore Energy*, 2012 WL 3792997, at *12 (alterations in original) (quoting *Nemec*, 991 A.2d at 1126).

30. *Id*.

31. *Id*.

32. In a role reversal, *see infra* note 23, Vice Chancellor Noble's subsequent *Gerber 2013* opinion drew heavily on *Encore Energy*'s reasoning. *See, e.g., Gerber 2013,* 2013 WL 209658, at *6 n.69 ("The analysis here is guided by the approach in *Encore Energy P'rs*"); *id.* at *11 ("The words of *In re Encore Energy Partners* are particularly appropriate here").

33. *Desert Equities*, 624 A.2d at 1206.

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