HUNTON& WILLIAMS

Client Alert

December 2014

DE Court Upholds Claims Challenging Unreasonable Termination Fee Structure

In *In re Comverge, Inc. Shareholders Litigation*, the Court of Chancery recently denied a motion to dismiss a complaint which alleged that a board of directors acted in bad faith by approving an unreasonable termination fee structure in a merger agreement.[1] The termination fee purportedly was equal to 5.55% of the deal's equity value if triggered during a "go-shop" period and 7% of the deal's equity value if triggered afterwards. The plaintiff further argued that the potentially preclusive effects of these termination fees had to be assessed in conjunction with a convertible bridge loan provided by the buyer. The plaintiff claimed that, after giving effect to the convertible debt, a buyer would have to pay 11.6% to 13.1% of the transaction's equity value to submit a successful topping bid.

Background

The post-closing litigation involved the 2012 sale of Comverge, Inc. to a private equity fund. At the time, Comverge apparently was struggling financially and facing a potential default under its debt instruments. Of particular note, the buyer purchased some of Comverge's debt that had potential blocking rights over a sale of the company. During the merger negotiations, the buyer claimed that Comverge was in default and threatened to accelerate payment of the debt. The plaintiff argued, however, that the buyer's purchase of the debt violated a standstill covenant in its confidentiality agreement, and that Comverge's board of directors should have sued the buyer.

The definitive merger agreement included a 30-day go-shop period with a 10-day extension for certain qualified bids that were submitted by the end of the original go-shop period. The buyer also agree to provide a $12 million bridge loan, which was accompanied by a convertible note in which the buyer could obtain common stock at a price below the merger consideration. The transaction's total equity value was approximately $48 million. The per share price of $1.75 was below the stock's then-current trading price of $1.88 per share.

Court's Decision

In ruling on the defendants' motion to dismiss, the court found that the stockholder-plaintiff had failed to allege that a majority of the directors acted with an improper purpose. In that regard, the directors held a material amount of the company's stock and all but one were independent. The court also deferred to the board's judgment not to sue to enforce the standstill agreement, and to focus instead on seeking improved terms in the merger agreement. The court noted that the buyer was the only bidder at that time, the litigation had the potential to be costly and time-consuming, and recovery was uncertain.

The court did find that it was reasonably conceivable that "the ultimate merger price was far enough 'off-the-mark' as to implicate the fiduciary duty of care." As is typical among Delaware corporations, however,

[1] *In re Comverge, Inc. S'holders Litig.*, Consol. C.A. NO. 7368-VCP (Del. Ch. Nov. 25, 2014).

the directors were exculpated from due care violations.[2] The court then held that the complaint failed to allege that the board breached its duty of loyalty in conducting the sale process. Among other things, the court noted that "the Board was highly engaged in the process, and this type of engagement precludes a finding of bad faith conduct."

Turning to the deal protections in the merger agreement, the court found that the 30-day go-shop period, along with the 10-day extension in certain circumstances, was reasonable. The court explained that Delaware law "places more emphasis on the length of a post-signing go-shop if there was not an effective market check before signing." It then noted that the company had engaged in a prolonged search for strategic transactions before entering into the merger agreement.

The court then found that the termination fees of 5.55% of equity value (or 5.2% of enterprise value) during the go-shop period and 7% of equity value (or 6.6% enterprise value) after the go-shop period "test the limits of what this Court has found to be within a reasonable range for termination fees." The court also analyzed the termination fee in connection with the convertible note held by the buyer in connection with the bridge financing. The plaintiff alleged that the conversion feature in the note, which allowed the buyer to purchase common stock at a price below the merger consideration, would significantly increase the cost to a topping bidder of acquiring the company. Factoring in that cost to the existing termination fee, the plaintiff argued, would result in a total payment equal to 11.6% of the deal's equity value during the go-shop period and 13.1% of the deal's equity value after the go-shop period.

The court concluded that, for purposes of surviving a motion to dismiss, it was "reasonably conceivable that the Convertible Notes theoretically could have worked in tandem with the termination fees effectively to prevent a topping bid" from a buyer that might otherwise offer greater value to the company's stockholders. Perhaps more importantly, the court found that the plaintiff adequately alleged that the board of directors acted in bad faith in approving these terms. The court said that "it conceivably is true that the Board's apparently passive acceptance of those terms without any pushback was 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any grounds other than bad faith." In so doing, the court noted that this was "a deal with a *negative* premium to market" when it was announced.

Conclusion

Despite the amount of litigation challenging M&A transactions, there are not many Delaware rulings that have upheld challenges to deal protections such as termination fees, matching rights, and no-shop provisions. This is because the Delaware courts have generally created a body of precedent that provides helpful guidance to buyers and sellers and also recognized the value of such terms. In *Comverge*, the parties appear to have deviated from this precedent, but more importantly, the court looked to the bridge loan to view the aggregate effect of the various terms on the ability of a third party to make a topping bid.

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[2] Comverge's certificate of incorporation contained a provision authorized by Section 102(b)(7) of the Delaware General Corporation Law that exculpated its directors for breaches of the duty of care.

