# HOW DOES ONE LOCK-UP A FRIENDLY DEAL AFTER OMNICARE V. NCS?

## Keywords:
corporate law, M&A, Delaware law, duty of care, deal protection device, fiduciary out, lock-up

**Tero Rehula**[1]

## ABSTRACT

Deal protection devices are contractual terms in a merger agreement. They motivate parties to consummate the underlying transaction. The Delaware Supreme Court held in its 2003 decision, Omnicare Inc. v. NCS Healthcare Inc. ("Omnicare"), by a 3 to 2 vote, that the NCS board had breached its fiduciary duties by accepting deal protection devices that created "an absolute lock-up".[2] The Omnicare decision created a new legal rule: the target board has to retain an effective fiduciary out provision that allows the board to terminate the deal if it receives a superior proposal from another company. However, due to other courts' narrow construction of Omnicare and practitioners' creative crafting of new deal protection devices, there is a good reason to believe that Omnicare has limited applicability today.

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1 The author is a master's student of law at the University of Helsinki and a student of business at the Hanken School of Economics. The article is based on a seminar paper the author wrote during his exchange semester at Hofstra Law School in New York, US in 2014.

2 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 945 (Del. 2003).

# I INTRODUCTION

This is an article about corporate law of the state of Delaware, United States. Most of the publicly traded companies in the United States are incorporated in the state of Delaware. Corporate law of Delaware is modern and predictable.[3] Both the Court of Chancery of the State of Delaware and the Delaware Supreme Court are specialized in corporate law matters. Courts in many other states in the US have bound themselves to decisions of the Delaware Supreme Court. Further, the Delaware Supreme Court has a significant role in development of corporate law all over the world. Also Finnish legislator was interested in Delaware corporate law when preparing the 2006 Limited Liability Companies Act of Finland.[4]

The Delaware Supreme Court held in its 2003 decision, Omnicare Inc. v. NCS Healthcare Inc., by a 3 to 2 vote, that the NCS board breached its fiduciary duties by accepting the merger agreement and the voting agreement that absolutely locked-up the deal whereby Genesis Health Ventures would have acquired NCS. By entering into the agreements and approving certain deal protection devices, the NCS board tried to protect itself from the potential loss of the Genesis transaction. The Omnicare decision created a new legal rule: an absolute lock-up, which contains a binding majority stockholder approval and does not contain a fiduciary out provision allowing the board to terminate the deal if it receives a superior proposal from another company, is per se, in itself, invalid when a later significant topping bid emerges.

Omnicare made it more difficult for bidders to achieve the certainty they usually require before signing a friendly acquisition. As a theoretical result, because certainty itself has value, potential target companies could have received lower bids after Omnicare, which in turn decreases value to targets' shareholders. The dissenting Justices were worried about loss of certainty and stated that Omnicare had not followed Delaware's prior case law.[5] Many scholars and practitioners agree. At the time of writing this article, the Delaware Supreme Court has not decided cases similar to Omnicare since Omnicare v. NCS. However, the Delaware Chancery court has continuously interpreted Omnicare narrowly in several decisions. Also, some courts outside of Delaware applying Delaware law have declined to apply Omnicare.

The goal of this article is to answer to the question stated in title: how does one lock-up a friendly deal after Omnicare v. NCS? Even though the question is practical, the core problem is theoretical. From a broader perspective, the article is about limits of duty of care the board of directors owes to the company and its shareholders. Research method follows American tradition and is strongly based on case analysis.

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3 Del. Code Ann. tit. 8.

4 HE 109/2005 vp & Osakeyhtiölakityöryhmän mietintö 2003:4.

5 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939–950 (Del. 2003).

# 2 LOCKING-UP A PUBLIC CORPORATE ACQUISITION

## 2.1 Context of Public Corporate Acquisitions

At first, it is necessary to talk about the wider context of the problem. Buying and selling corporations and corporate assets is part of many publicly traded companies' business. Initiative to potential merger can come from the acquiring company or from the target company. A company may want to acquire another company for various reasons, such as possible synergic benefits, possible competitive advantages, expanding to new markets, fears of new competitors, or new regulations. In a stock purchase, the acquiror has to pay a control premium of sorts to the target's shareholders. The total purchase price usually exceeds significantly the market gap of the target.

Companies may also want to sell their existing businesses in order to focus only on their core businesses. Sometimes the board of directors can put a whole company up for sale if it faces financial problems, or if the board otherwise decides that the best strategy for the company is to forego a strategic transaction. Once the company is on sale, soliciting bids and running an auction with the potential buyers usually guarantees the highest purchase price. However, there are many economically rational reasons why the target wants to limit the number of potential buyers with which it is negotiating: the target does not want to allow all its rivals to engage in due diligence, the target involved in a bidding war faces increased costs, and promising certainty to one bidder can lead to a raised bid from that bidder.

Under Delaware law, both merger and sale of substantially all property and assets require shareholders' approval.[6] The board's approval is not required for merger, but the board is obligated to recommend to the shareholders that they either approve or decline a launched tender offer.[7] Deals in which the board recommends shareholders to approve a merger are commonly called friendly deals. On the other hand, proposed mergers that do not get the board's approval are described as hostile takeovers. In a friendly deal the target and the acquiror usually negotiate the merger terms, and at the time of signing, both parties believe that the deal is in the best interests of the signing parties. Next, I will explain the purpose of lock-up and take a look into different deal protection devices.

## 2.2 The Purpose of Lock-Up

No acquiring company wants to be used as a stalking horse that puts in all the effort and money to make due diligence and reasonable valuation of the target – only to have its bid then used as

6 Del. Code Ann. tit. 8, § 251(c) & Del. Code Ann. tit. 8, § 271(a).

7 Del. Code Ann. tit. 8, § 251(b).

a benchmark for new bids by other bidders.[8] Because of this risk, the acquiror's goal is to negotiate exclusively with the target, and sign the deal quickly. The target company can also be under pressure to get the deal done quickly if it is otherwise facing liquidation. If there is only one company interested in acquiring the target, courts have described potential buyer as the only game in town.[9] When this is the case the target has a huge incentive not to lose the acquiror.

Once the deal is signed, it takes a relatively long time to close it. The time depends on various factors, such as when the shareholder voting takes place; whether the bidder obtains necessary financing; and whether the deal receives necessary approvals regarding anti-trust regulations. The time period between the signing and the closing is risky for both the target and the acquiror. Changes that may occur in the interim can cause the other party to change its mind. The acquiror's nightmare is that the target company receives a more attractive competitive bid from another bidder. The risk of the acquiring company walking away from the deal is significantly lower.

Parties cannot trust with full certainty that the deal will be closed before it actually is closed. This uncertainty causes costs to the parties, as actors in capital markets give value to certainty itself.[10] The more likely the deal is to actualize, the higher price the acquiring company is willing to pay.[11] In theory, if the board of the target company knew with certainty that there will not be any other bidders on the market, it could be even the board's duty to create a strong lock-up in order to reach the highest possible price. Because in reality the board can never know certainly that no higher bid will emerge, deal protection devices increase the risk that the target company has to turn down a more valuable potential transaction later. Further, deal protection devices can make it so expensive to later potential bidders to succeed that they will not even make an offer. Thus, by restricting the target company's ability to negotiate other transactions, deal protection devices create a potential cost to the target company.

## 2.3 Deal Protection Devices

Deal protection devices are contractual terms in the merger agreement, or in the documents related to it. There is not a complete list of all possible deal protection devices, but rather transactional lawyers continuously develop new ways to reduce the risk and protect the deals. The main purpose of deal protection devices is to motivate the parties to consummate the underlying transaction, and thus reduce the risk of losing the deal.

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8 Smith v. Van Gorkom, 488 A.2d 858, 866 (Del. 1985).

9 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 943 (Del. 2003).

10 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 942 (Veasey, C.J., dissenting) (Del. 2003) & Gilson 1984 at 264.

11 Gilson 1984 at 264.

The most used deal protection device is a termination fee that requires the target company to pay a fee to the acquiring company if the target company fails to close the transaction. Termination fees can be triggered by different events. These include the target board's failure to put the merger to shareholder vote, the board's withdrawal of its recommendation, a negative shareholder vote, or the closing of an alternative transaction.[12]

Stock and asset options grant the acquiring company the right to purchase specified amounts of stock or specified assets of the target company at a stated price – a price that is lower than market price. These kinds of options make it more expensive for other bidders to succeed in a bidding war. Today, acquiring companies prefer stock options because the Delaware Supreme Court has been more suspicious toward asset options and has invalidated them more frequently.[13]

A no-shop provision prohibits the target company from actively marketing itself to other potential bidders. However, it allows the target company to negotiate with an unsolicited bidder, at least if its bid is superior to the terms of the original acquiring company's offer.[14] So called no-talk provisions go further, and prohibit the target company from even talking or delivering information to an unsolicited bidder.

Acquiring company can also make a voting agreement with the target's shareholders who agree to approve the merger. Delaware law permits force to vote provisions, meaning that the target company's board can agree to submit a merger agreement for a stockholder vote, even if the board later decides not to support the agreement and recommends that the stockholders reject it.[15] The target company and the acquiring company can also agree that the acquiror has the right to match a potential superior bid within a specified period of time. That is sometimes called a last look provision.[16] If the acquiror also has the right to get all the information that the potential new buyer gets from the target, this provision is called a matching information provision.

Now, when we understand why deal protection devices are so important and how they work, I will turn focus into fiduciary duties of a board of directors.

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12 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 39 (Del. 1994).

13 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 175-176, 178 (Del. 1986) & Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 (Del. 1989).

14 In re Pennaco Energy, Inc. S'holders Litig., 787 A.2d 691, 702 (Del. Ch. 2001).

15 Del. Code Ann. tit. 8, § 251(c).

16 La. Mun. Police Employees' Ret. Sys. v. Crawford, 918 A.2d 1172, 1180 (Del. Ch. 2007).

## 2.4 Director's Fiduciary Duties in Public Transactions

### 2.4.1 The Business Judgment Rule

Under Delaware law, the business and affairs of every corporation shall be managed by, or under the direction of, a board of directors.[17] The Supreme Court of Delaware has held that "[t]he existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders"[18], and that "[t]he director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty."[19] In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. ("Revlon") the Supreme Court of Delaware ruled that "[t]hese principles apply with equal force when a board approves a corporate merger... and of course they are the bedrock of our law regarding corporate takeover issues."[20]

The business judgment rule protects decision-making of a board of directors, and shields directors from judicial second-guessing. It is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company".[21] An application of the business judgment rule places the burden of proof on the party challenging the board's decision.[22] The Supreme Court of Delaware has, however, created heightened standards for review of certain actions of the board of directors. "Where issues of corporate control are at stake [as in a merger], there exists the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[23] For that reason, the board will not receive the normal protections of the business judgment rule, unless its decision satisfies enhanced scrutiny.[24] The Delaware Supreme Court has developed two different applications of the enhanced scrutiny: Unocal and Revlon standards. It is necessary to explain those standards.

### 2.4.1 The Unocal standard

Unocal applies whenever a board "perceives a threat" to control and takes defensive measu-

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17 Del. Code Ann. tit. 8, § 141(a).

18 Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

19 Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998).

20 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d at 179 (Del. 1986).

21 Aronson v. Lewis, 473 A.2d at 812 (Del. 1984).

22 Ibid.

23 Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d at 1287 (Del. 1989).

24 Ibid.

res in response to the threat.[25] A threat to control is defined as "threat to corporate policy and effectiveness which touches upon issues of control."[26] Adopting defensive measures against a hostile bidder in a takeover contest triggers Unocal. Analogously, a board's decision to protect its decision to enter into a merger agreement with defensive devices against uninvited competing transactions triggers Unocal.[27] In Unocal Corp. v. Mesa Petroleum Co. ("Unocal") the Supreme Court of Delaware came up with the new standard of review.[28]

Where the Unocal test is applicable, before the board is accorded the protection of the business judgment rule, "the board must establish: (1) that it had reasonable grounds to believe that the hostile bid for control threatened corporate policy and effectiveness; and (2) that the defensive measures adopted were reasonable in relation to the threat posed."[29] The first part is called the reasonableness test and the second part is called the proportionality test.[30] The proportionality inquiry involves a two-step analysis: "if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a 'range of reasonableness,' a court must not substitute its judgment for the board's".[31] A response is "coercive" if it is aimed at forcing upon stockholders a management-sponsored alternative to a hostile offer.[32] A response is "preclusive" if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise.[33]

### 2.4.2 The Revlon standard

In a Revlon situation, the board no longer faces threats to the corporate policy or effectiveness. Instead, it becomes obvious that the target company is on sale. Revlon standard applies at least in the following three scenarios "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company"; "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company"; or "when approval of a transaction results in a sale or change of control".[34]

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25 Stroud v. Grace, 606 A.2d 75, 82 (Del. 1992).

26 Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990).

27 Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989).

28 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.1985).

29 Chesapeake Corp. v. Shore, 771 A.2d 293, 330 (Del. Ch. 2000) (Rewriting the rules stated in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del.1985) & Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del 1995)).

30 Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995).

31 Ibid. at 1388.

32 Ibid. at 1387.

33 Ibid.

34 Arnold v. Soc'y for Savings Bancorp, Inc., 650 A.2d 1270, 1290 (Del. 1994).

Under Revlon, the board must perform its fiduciary duties by acting in a way that obtains the specific objective: "maximizing the sale price of the company for the stockholders' benefit."[35] This task is complex and it is up to the board how to best achieve the objective since "there is no single blueprint that a board must follow to fulfill its duties."[36] In Paramount Communications Inc. v. QVC Network Inc. ("QVC") the Delaware Supreme Court recognized that when the board makes its decision "there are many business and financial considerations implicated in investigating and selecting the best value reasonably available" and "the board of the directors is the corporate decision making body best equipped to make these judgments."[37] Accordingly, the Court held that "a court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision" and "thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness."

While the business judgment rule remains as a default standard when reviewing board's decisions, Unocal or Revlon may apply under certain circumstances. In Omnicare the Delaware Supreme Court applied Unocal. It also held that Revlon would have been satisfied, if it had applied, which it did not. Now it is time to turn our focus into the case itself.

# 3 THE LIMITS OF LOCK-UP SET BY OMNICARE

## 3.1 Factual Background and Holding in Omnicare

NCS Healthcare, Inc. ("NCS"), a Delaware company in pharmacy providing business, was insolvent in 2001.[38] The NCS's board began to explore strategic alternatives, and as a part of this effort it contacted over 50 companies concerning its acquisition.[39] The only interested buyers NCS found were Genesis Health Ventures, Inc. ("Genesis") and Omnicare, Inc. ("Omnicare").[40] Late 2001, Omnicare told NCS that it was not interested in any transaction other than an asset sale in bankruptcy.[41] Genesis, which had previously lost a bidding war to Omnicare in a different transaction, entered into negotiations with NCS.[42] Knowing that NCS had also negotiated with Omnicare, Genesis made it clear to NCS that it would not negotiate with NCS as a stalking horse.[43]

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35 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986).

36 Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989).

37 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del 1994).

38 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 919-920 (Del 2003).

39 Ibid. at 920.

40 Ibid. at 921.

41 Ibid.

42 Ibid.

43 Ibid. at 922.

NCS avoided bankruptcy and its operating performance improved constantly since early 2002.[44] In the spring of 2002 Genesis was the only company interested in negotiating with NCS.[45] The deal between NCS and Genesis was almost signed in late July 2002 when Omnicare again proposed negotiations with NCS and sent NCS a letter outlining a proposed merger.[46] NCS could not meet with Omnicare because of the exclusivity agreement with Genesis.[47] NCS also turned down Omnicare's otherwise attractive proposal because the due diligence condition substantially undercut its strength.[48] However, NCS used Omnicare's proposal to negotiate for improved terms with Genesis.[49] As a result Genesis substantially improved its terms, but threated to walk away from the deal unless NCS approved it by midnight for July 28, 2002.[50]

The proposed agreement contained a provision requiring that the Genesis agreement be placed before the NCS's stockholders for a vote, even if the NCS board no longer recommended it.[51] The agreement also demanded the NCS's board to agree to omit any effective fiduciary out clause from the merger agreement.[52] In connection with the Genesis agreement, the Genesis demanded two stockholders of NCS, who held a majority of the voting power, to agree unconditionally to vote all of their shares in favor of the Genesis merger.[53] Additionally, they had to grant Genesis an irrevocable proxy to vote their shares in favor of the agreement, and to agree that the voting agreement was specifically enforceable by Genesis.[54]

The full board met on July 28, 2002, and received reports and advice from its legal and financial advisors.[55] The board concluded that "balancing the potential loss of the genesis deal against the uncertainty of Omnicare's letter, results in the conclusion that the only reasonable alternative for the Board of Directors is to approve the Genesis transaction."[56] The board was informed that certain conditions in the agreement "would prevent NCS from engaging in any alternative

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44 Ibid.

45 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 922 (Del 2003).

46 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 924 (Del 2003).

47 Ibid.

48 Ibid.

49 Ibid.

50 Ibid. at 925.

51 Ibid.

52 Ibid.

53 Ibid.

54 Ibid. at 926.

55 Ibid. at 925.

56 Ibid.

or superior transaction in the future."[57] The merger agreement and the voting agreement were executed later that day.[58]

Hours after the deal was signed, Omnicare proposed a merger agreement to NCS and publicly disclosed the proposal.[59] A couple of days after that, Omnicare sought to enjoin the NCS/Genesis merger, and announced its intention to launch a superior tender offer within few days.[60] The NCS board later withdrew its recommendation of the Genesis merger and recommended stockholders to vote against the Genesis merger because of the superior bid by Omnicare.[61] However, the NCS board knew that there was no way to prevent Genesis merger closing.[62]

On August 1, 2002, Omnicare filed a lawsuit attempting to enjoin the NCS/Genesis merger.[63] The court held that the deal protection devices contained in the merger agreement and in the voting agreement were subject to the Unocal enhanced judicial scrutiny test.[64] The threat identified by the NCS board was the possibility of losing the Genesis offer and being left with no comparable alternative transaction.[65] The court found NCS board's deal protection devices both coercive and preclusive.[66] Stockholder vote had been robbed of its effectiveness to determine "the outcome of the merger without regard to the merits of the Genesis transaction at the time the vote was scheduled to be taken".[67] Stockholders were required to accept the merger agreement because it was a fait accompli. The court held that the defensive devices employed by the NCS board were coercive and preclusive in the sense that they accomplished a fait accompli.[68] Consequently, because the defensive devices were coercive and preclusive, they could not be within a reasonable range of responses to the threat.[69]

Alternatively, the Court held that the defensive devices were invalid and unenforceable because

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57 Ibid.
58 Ibid
59 Ibid. at 926.
60 Ibid.
61 Ibid.
62 Ibid. at 927.
63 Ibid. at 926.
64 Ibid. at 934.
65 Ibid. at 935.
66 Ibid.
67 Ibid. at 936.
68 Ibid.
69 Ibid.

they provided no effective fiduciary out.[70] Relying on QVC, the court stated that since stockholders had lost the power to influence corporate direction through the ballot, "minority stockholders must rely for protection solely on the fiduciary duties owed to them by the directors".[71] Altogether, the specifically enforceable voting agreement, a force to vote provision, and omission of a fiduciary out clause prevented the board from discharging its fiduciary responsibilities to the minority shareholders when Omnicare presented its superior proposal.[72] Combined together, all these otherwise valid actions operated in concert – creating an absolute lock-up with no effective fiduciary out.[73] Next I will look deeper into the legal consequences of Omnicare.

## 3.2 Omnicare Set New Rules for Lock-Ups

The court held in Omnicare, citing its 1989 decision Paramount Communications, Inc. v. Time Inc. ("Time-Warner"), that defensive devices adopted by the board to protect the original merger transaction must withstand enhanced judicial scrutiny under the Unocal standard.[74] In Time-Warner, the Time Inc. board adopted defensive devices in response to Paramount Communication, Inc.'s attempt to acquire Time Inc. after the merger agreement between Time Inc. and Warner Communication, Inc. was executed.[75] The only threat the court found to NCS in Omnicare was Genesis running away from the deal.[76] The same court held in 1996 in Williams v. Geier that "[a] Unocal analysis should be used only when a board unilaterally (i.e. without stockholder approval) adapts defensive measures in reaction to a perceived threat."[77] In Omnicare, the whole merger process and signing the agreement was a joint decision by the controlling shareholders and the board of directors "to secure what appeared to be the only value-enhancing transaction available for a company on the brink of bankruptcy".[78] Regardless of the nature of the threat and the rule stated in Williams v. Geier the court applied the Unocal enhanced scrutiny test.

Pre-Omnicare legal rule was stated in Revlon: "[a] lock-up is not per se illegal under Delaware

70 Ibid.

71 Ibid. at 937 (Citing Paramount Commc'ns Inc. v. QVC Network, Inc. 637 A.2d 34, 43 (Del 1994)).

72 Ibid. at 936.

73 Ibid. at 939.

74 Ibid. at 931 (Citing Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1151-55 (Del. 1989)).

75 Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989).

76 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 935 (Del. 2003).

77 Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996).

78 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 940 (Veasey, C.J., dissenting) (Del. 2003).

law".[79] However, in Omnicare the Court held that an absolute lock-up is per se illegal.[80] The decision prohibits the board acting in concert with controlling shareholders in a way that results in an absolute lock-up.[81] Omnicare created a new legal rule, by which an absolute lock-up, containing stockholder approval, but not a fiduciary out provision, is per se invalid when a later significant topping bid emerges.[82] According to dissenting Chief Justice Veasey, "per se rule would apply regardless of (1) the circumstances leading up to the agreement and (2) the fact that stockholders who control voting power had irrevocably committed themselves, as stockholders, to vote for the merger."[83] Omnicare did not follow Delaware's prior case law.

## 3.3 Omnicare's Dissents and Critique

Omnicare was a 3 to 2 decision, and each dissenting Justice wrote his own dissent.[84] The dissenting Justices disagreed with the majority's approach of applying heightened scrutiny in its evaluation of the deal protection devices. The dissenting Justices would not have applied the Unocal test in Omnicare, because the majority stockholders had approved the NCS board's actions, and the actions were neither defensive nor reactive in nature.[85] The dissenting Justices were of the opinion that the business judgment rule was the correct standard of review.

Nevertheless, dissenting Chief Justice Veasey stated that even if Unocal applied, the deal protections devices that the NCS board agreed were neither coercive nor preclusive.[86] They were "an integral part of the merits of the transaction" and there would not have been deal without these provisions.[87] Chief Justice Veasey found it problematic that the majority of the Justices interpreted the provisions outside their proper context.[88]

In the context of insolvency and creditor pressure, the NCS board concluded a lengthy search to find a potential bidder.[89] The NCS board was informed about the deal protection devices in the merger agreement and about how they resulted an absolute lock-up.[90] The board understood

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79 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986).

80 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 940 (Veasey, C.J., dissenting) (Del. 2003).

81 Ibid.

82 Ibid. at 942.

83 Ibid. at 942–943.

84 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939–950 (Del. 2003).

85 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 943 n.102 (Veasey, C.J., dissenting) (Del. 2003).

86 Ibid. at 944–945.

87 Ibid. at 944.

88 Ibid. at 940.

89 Ibid.

90 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 925 (Del. 2003).

that the deal with Genesis prevented NCS from accepting any alternative or superior transaction in the future. Since Omnicare's last proposal was not strong enough with the due diligence clause, the NCS board's reasonable determination was that Genesis was the only game in town.[91] At the time the deal was signed the NCS board reasonably believed that a superior offer neither existed, nor was likely to emerge. The agreement with the absolute lock-ups was signed in the best interests of stockholders, and majority stockholders approved it.[92] By approving the deal protection devices, the NCS board avoided the reasonable risk that Genesis would abandon the deal, and maximized the price Genesis was willing to pay to acquire the NCS.[93]

As to the minority shareholders, Chief Justice Veasey found that there was no meaningful minority shareholder voting decision to coerce, because the minority shareholders were deemed to know that controlling shareholders could approve a merger without a need for the minority votes.[94] In conclusion, the Chief Justice Veasey expressed his hope that the majority rule would be construed narrowly in the future and seen as sui generis.[95]

Dissenting Justice Steele joined the Chief Justice's dissent, but wrote a separate dissenting opinion. He emphasized that at the time the NCS board and the majority shareholders agreed on a voting lock-up, "the terms were the best available for all the stockholders, balanced against a genuine risk of no deal at all".[96] Justice Steele stated that the new rule of law of Omnicare requires a board, in order to obtain the highest price, to breach a merger contract entered into at the time when no one could have reasonably foreseen a truly superior proposal.[97]

The scholars discussing the Omnicare have described it as "bad law, bad economics, and bad policy".[98] Shortly after the Omnicare decision scholars and practitioners were afraid that the decision would negatively impact the mergers and acquisitions market.[99] The Omnicare decision "deprived target boards both of a negotiating strategy (precommitment) and an exchangeable commodity (certainty)".[100] Because a lock-up creates valuable certainty, the absence

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91 Ibid. at 924.

92 Ibid. at 925.

93 Ibid.

94 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 944-945 (Veasey, C.J., dissenting) (Del. 2003).

95 Ibid. at 946.

96 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 948 (Steele, J., dissenting) (Del. 2003).

97 Ibid.

98 Griffith 2004 at 623, Veasey & Di Guglielmo 2005 at 1458, and Shaner 2014 at 755.

99 Griffith 2004 note 91 at 614, Arons 2004 at 130, and Shaner 2014 note 91 at 776.

100 Griffith 2004 note 91 at 622.

of lock-up decreases the value of a deal.[101] Ultimately, limits to lock-ups set by Omnicare led to decreased value for targets and their stockholders.[102] Next I will look into post-Omnicare case law in Delaware and other states.

# 4 OMNICARE'S LIMITED APPLICABILITY

At the time of writing this article in March 2015, the Delaware Supreme Court itself has not decided any post-Omnicare cases relevant to construing the new legal rule it set in Omnicare. The Delaware Chancery Court has construed Omnicare's holding narrowly, as suggested by the dissenting Justices. Also, some courts outside Delaware, when applying Delaware law, have avoided the rules set forth in Omnicare. I will review these decisions later. Instead of applying the Unocal enhanced scrutiny standard to deal protection devices, courts have applied the original business judgment standard. Courts have also tried to distinguish Omnicare on its facts. Additionally, transaction lawyers have come up with new kinds of deal protections devices that can easily be distinguished from the ones used in Omnicare. I will briefly clarify those new kinds of deal protections devices, too. But first, let us walk through relevant case law interpreting Omnicare.

## 4.1 Orman v. Cullman

General Cigar Holdings, Inc. ("General Cigar"), a leading manufacturer and marketer of premium cigars, was controlled by the Cullman family through the Class B common stocks that were entitled to ten votes per share.[103] In late 1999, Swedish Match AB ("Swedish Match"), another tobacco company, contacted General Cigar to discuss acquiring a significant stake in General Cigar's business.[104] Swedish Match also indicated that they wanted two of the Cullmans to maintain management responsibility and day-to-day control of General Cigar after the deal.[105] Swedish match proposed a merger in which the surviving company would be owned primarily by Swedish Match, but the Cullmans would retain voting control.[106]

The board of General Cigar approved the merger agreement on January 19, 2000.[107] Also, the Cullman family entered into a voting agreement, whereby the Cullmans agreed not to sell their shares, and to vote their shares against any alternative acquisition proposal for 18 months

101 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 942 (Del. 2003).

102 Griffith 2004 note 91 at 622.

103 Orman v. Cullman, 2004 WL 2348395 at 1 (Del. Ch. 2004).

104 Ibid.

105 Ibid. at 2.

106 Ibid.

107 Ibid. at 3.

following the termination of the merger agreement.[108] The merger agreement further provided that the merger could not proceed without approval by a majority of the minority, Class A public shareholders.[109] This gave the minority shareholders a veto over the proposed merger. Public shareholders overwhelmingly approved the merger.[110] A shareholder Joseph Orman sued the General Cigar board in a class action for breach of its fiduciary duties in negotiating the merger terms.[111]

The Delaware Chancery Court applied the Unocal enhanced scrutiny test to the deal protection devices. It held that a danger to corporate policy and effectiveness existed because without approving the deal protection devices, the board risked losing the Swedish Match transaction and being left with no comparable alternative transaction.[112] The court did not find the deal protection devices coercive because "General Cigar's public shareholders retained the power to reject the proposed transaction with Swedish Match, the fiduciary out negotiated by General Cigar's board was a meaningful and effective one—it gave the General Cigar board power to recommend that the shareholders veto the Swedish Match deal."[113] An 18-month delay was not a meaningful "cost" that could realistically "coerce" the shareholders' vote.[114] Finally, the court stated that the deal protection devices were within a range of reasonable responses to the danger to corporate policy and effectiveness since without the deal protection mechanisms there would have been no merger.[115] At the time of the signing of the agreement, there were no other deals in sight.[116] To General Cigar, it was this deal or nothing.

In Orman v. Cullman the court rejected Omnicare's applicability. First, the General Cigar board retained a fiduciary out, allowing it to consider superior proposals.[117] Second, nothing in the combination of merger and voting agreements made it "mathematically certain" that the transaction would be approved.[118] The deal protections devices were not a fait accompli. Only the Cullmans locked-up their votes against any hypothetical future deal for 18 months. The court stated that Orman's concept of construing and 18-month delay as coercion is "far more expan-

108 Ibid. at 2.
109 Ibid. at 3.
110 Ibid.
111 Ibid. at 1.
112 Ibid. at 7.
113 Ibid.
114 Ibid. at 8.
115 Ibid.
116 Ibid.
117 Ibid.
118 Ibid.

sive than Omnicare or any other decisional authority brought to my attention."[119] In conclusion, Orman held a lock-up to be acceptable as long as shareholders retain the power to say no to the locked-up deal, even if they would not have the ability to say yes to an alternative deal. In Omnicare shareholders did not even have the power to say no.

## 4.2 In re Orchid Cellmark Inc. Shareholder Litigation

Laboratory Corporation of America Holdings, Inc. ("LabCorp") intended to acquire Orchid Cellmark Inc. ("Orchid") through a cash tender offer in the fall of 2008 but Orchid determined the proposed price as inadequate and negotiations ceased.[120] In August 2010, LabCorp contacted Orchid again to express an interest in reopening acquisition discussions. Finally in April 5, 2011, the merger agreement was executed.[121] The agreement contained many deal protection devices such as a top-up option, a no-shop clause, matching and informational rights guaranteeing LabCorp the right to match possible other offers and to receive the same information Orchid shares with other bidders. The agreement also contained a termination fee payable either where Orchid pulled out of the deal or where shareholders failed to tender a majority of shares.[122] Additionally, Orchid agreed to pull its poison pill with regard to LabCorp, meaning only that the pill remained in place with respect to all other potential bidders.[123]

The Delaware Chancery Court held that "the cumulative deterrent effect of all the deal protection measures in the Merger Agreement is greater than simply the sum of the effects of the individual provisions, and thus I must evaluate the cumulative effect of the deal protection devices in light of all the circumstances of the Proposed Transaction."[124] While measuring the sum of all devices, the court stated that some day "some judge is going to say 'no more'".[125] However, the court concluded that the deal protection measures included in the merger agreement were reasonable under the circumstances and another sophisticated buyer could "navigate those shoals if it wanted to make a serious bid".[126]

The court decided Orchid under the reasonableness standard and held that the cumulative effect of all the deal protection devices was still within the range of reasonableness. The facts in Orchid differ significantly from those in Omnicare, but the Orchid decision offers advice to

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119 Ibid.

120 In re Orchid Cellmark Inc. Shareholder Litigation, 2011 WL 1938253 at 1 (Del. Ch. 2011).

121 Ibid.

122 Ibid. at 6.

123 Ibid.

124 Ibid. at 8.

125 Ibid.

126 Ibid.

parties asking how to effectively lock-up a friendly deal without target's board breaching its fiduciary duty.

## 4.3 Optima International of Miami v. WCI Steel

After emerging from bankruptcy in 2006, WCI Steel, Inc. ("WCI") again ran into some real trouble, and in summer 2007 it engaged in a lengthy process looking for possible bidders to buy the company.[127] WCI solicited 22 potential buyers. Only two bidders remained by April 2008: OAO Severstal ("Severstal") and Optima International of Miami, Inc. ("Optima").[128] WCI was operating under a collective bargaining agreement that gave the United Steelworkers Union a right to deal executively with the bidder of its choice.[129] The Union decided to support Severstal.[130] As a result, Optima's final bid was conditioned upon Union's approval, which it was unlikely to obtain. On May 16, 2008, WCI approved Severstal's final bid even though it was lower in price than Optima's final bid.[131] Only a few minutes later, the WCI board approved the agreement and the board received written consent from two shareholders, who together owned 51% of the voting power, approving the merger.[132]

Optima sought to enjoin the Severstal merger because it violated the rules set by Omnicare and Revlon. The Delaware Chancery Court distinguished stockholder consent in WCI from the voting agreement in Omnicare.[133] "The stockholder vote, although quickly taken, was simply the next step in the transaction as contemplated by the statute. Nothing in the DGCL requires any particular period of time between a board's authorization of a merger agreement and the necessary stockholder vote."[134] The Court of Chancery applied Revlon rule to the transaction but clearly stated that the WCI board's decision fell within the range of reasonableness.[135]

Instead of signing a voting agreement in Omnicare, the major shareholders could just have had acted in consent right after the board's approval of merger. Materially, this does not seem to make almost any difference, but the court approved it. Additionally, the court stated "Omnicare is of questionable continued vitality".[136] This, of course, should ring a bell. A lower court

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127 Optima Int'l of Miami, Inc. v. WCI Steel, Inc., C.A. No. 3833-VCL at. 118–119 (Del. Ch. June 27, 2008).

128 Ibid. at 120–121.

129 Ibid. at 121.

130 Ibid.

131 Ibid. at 129.

132 Ibid. at 137.

133 Ibid. at 127.

134 Ibid.

135 Ibid. at 130–131.

136 Ibid.

questioned the Supreme Court's ruling.

## 4.4 In re OPENLANE, Inc., Shareholders Litigation

OPENLANE, Inc. ("OPENLANE") was a vehicle leasing company owned 68% by its board members and executive officers.[137] By April 2010, OPENLANE's business was facing some problems and it started looking for strategic acquirers.[138] OPENLANE negotiated with potential acquirors over a year before it finally entered into a merger agreement with KAR Auction Services, Inc. on August 11, 2011.[139] The merger agreement required that OPENLANE's stockholders should approve the merger agreement by written consent within 24 hours of signing or otherwise the OPENLANE board could terminate the agreement without paying a termination fee.[140] OPENLANE received consents from the holders of a majority of its stock within 24 hours after the agreement was signed.[141] Additionally, the merger agreement contained a stringent no-solicitation provision with no fiduciary out and a condition to close the merger that at least 75% of the outstanding shares approve the merger agreement.[142]

On September 8, 2011, OPENLANE filed a proxy to those OPENLANE shareholders who had not already approved the merger agreement.[143] On the following day, an OPENLANE stockholder sought to enjoin the merger.[144] His claim was that the OPENLANE board breached its fiduciary duties by violation the requirements set out in Revlon and Omnicare.[145] Shareholder's Omnicare claim was that the OPENLANE board breached its fiduciary duties by agreeing to improper deal protection devices.[146] Specifically, the plaintiff alleged that "[t]he no-solicitation clause and the lockup of the shareholder vote through the combined voting power of OPENLANE's directors and executive officers are 'preclusive and coercive' in the absence of a fiduciary out provision."[147]

The Delaware Chancery Court disagreed, distinguishing the combination of deal protection devices from the combination used in Omnicare.[148] There was no stockholder voting agreement

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137 In re OPENLANE, No. 6849-VCN, 2011 WL 4599662 at 1 (Del. Ch. 2011).

138 Ibid.

139 Ibid. at 3.

140 Ibid.

141 Ibid.

142 Ibid.

143 Ibid.

144 Ibid.

145 Ibid. at 4.

146 Ibid.

147 Ibid.

148 Ibid. at 9.

that required stockholders to vote yes.[149] Nothing in the Delaware law prevents stockholders from manifesting their approval to a merger through written consent soon after approval by the board.[150] Citing Optima, the court held that "if stockholders wish to submit their consents soon after the board has approved a transaction, they may do so".[151] In fact, the agreement allowed the board to terminate the agreement without paying a termination fee if it failed to receive the stockholder approval within 24 hours.[152] Unlike the transaction in Omnicare, the court found that the OPENLANE merger was not a fait accompli.[153] The decision confirmed that stockholders could approve a merger agreement by written consent shortly after the board approved it. This structure created a strong lock-up that did not fall into the category of "absolute lock-up" which violates Omnicare.

## 4.5 Non-Delaware Cases

The New York Supreme Court, applying Delaware law, decided "Bear Stearns Litigation". Due to severe financial problems, the Bear Stearns Companies Inc. ("Bear Stearns") was the target of a government-supported stock-for-stock merger with J.P. Morgan Chase & Co ("J.P. Morgan") in March 2008.[154] The merger agreement was protected by a "lock-up stock sale" that guaranteed Bear Stearns to issue to J.P. Morgan almost 40% of its common stock, an asset option for J.P. Morgan to purchase Bear Stearns' corporate headquarters at Manhattan, and a no-shop clause with a fiduciary-out.[155] The Bear Stearns shareholders argued that the board breached its fiduciary duty by approving an inadequate purchase price and a coercive combination of the deal protection devices.[156]

The court held that neither Unocal nor Revlon enhanced scrutiny applied, and even if they did, the board would have satisfied both of them.[157] "Unocal is inapplicable in a case where the board initiates the transaction in the absence of [a hostile third party] threat" and accordingly, "the deal protection measures are reviewable only under the business judgment rule".[158] The court explicitly rejected applicability of the Unocal test to deal protection devices, which was

149 Ibid. at 10.

150 Del. Code Ann. tit. 8, § 228(a).

151 In re OPENLANE, No. 6849-VCN, 2011 WL 4599662 at 10.

152 Ibid. at 9.

153 Ibid.

154 In re Bear Stearns Litig., 870 N.Y.S.2d 709, 722 (N.Y. Sup. Ct. 2008).

155 Ibid. at 730.

156 Ibid. at 727–730.

157 Ibid. at 731–732.

158 Ibid. at 733–734.

set forth in Omnicare.

In North Carolina litigation Ehrenhaus v. Baker, Wachovia Corporation ("Wachovia") faced significant financial problems and the board began to consider the selling of the company in late 2008.[159] From two potential acquirors, Wells Fargo & Company ("Wells Fargo") and Citigroup, Inc. ("Citigroup"), Wachovia agreed a stock-for-stock transaction with Wells Fargo on October 3, 2008.[160] The transaction contained no-shop and force to vote provisions, and granted Wells Fargo almost 40% of the votes to be cast on the Merger Agreement.[161] The shareholders claimed that the board breached its fiduciary duties by approving the Wells Fargo merger arguing that it was coercive and preclusive.[162]

The North Carolina Superior Court applied the North Carolina law in Ehrenhaus v. Baker but stated "the North Carolina courts frequently look to Delaware for guidance on questions of corporate governance because of the special expertise and body of case law developed in the Delaware Chancery Court and the Delaware Supreme Court."[163] This case was then appealed and decided by the Court of Appeals of North Carolina on October 4, 2011, but the issues on appeal were not relevant to lock-ups.[164] Like the New York Supreme Court in Bear Stearns, the North Carolina Superior Court held that the applicable standard of review to deal protection devices is the business judgment rule.[165] The court also stated that the transaction was not locked-up because a 60 % majority of Wachovia shareholders remained still "freely vote for or against the merger, based on their own perceived best interests".[166]

## 4.6 What Kind of Lock-Ups Have M&A Practitioners Crafted Since Omnicare?

Today, the American Bar Association's Model Merger Agreement for the Acquisition of a Public Company includes over 30 different types of lock-ups.[167] In practice, the use of lock-ups has expanded significantly, and the lock-up provisions in merger agreements have become longer

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159 Ehrenhaus v. Baker, Civil Action No. 08 CVS 22632, 2008 WL 4787594, at *29 (N.C. Super. Ct. Nov. 3, 2008).

160 Ibid. at **69-70.

161 Ibid. at **2, 55-56.

162 Ibid. at **81-82.

163 Ibid. at *90 n.19.

164 Ehrenhaus v. Baker, 717 S.E.2d 9 (N.C. Ct. App. 2011).

165 Ehrenhaus v. Baker, Civil Action No. 08 CVS 22632, 2008 WL 4787594, at *117.

166 Ibid. at **140-142 (Citing In re IXC Commc'ns, Inc. S'holders Litig., Consolidated C.A. No. 17324, 1999 Del. Ch. LEXIS 210, at *23 (Del. Ch. Oct. 27, 1999)).

167 Merger & Acquisitions Comm., ABA, Model Merger Agreement for the Acquisition of a Public Company (2011), §§ 4.4, 4.6, 148-65, 169-89.

and more complicated.[168] This phenomenon has even been described as "lock-up creep".[169] It can be said that dissenting Chief Justice Veasey was right in Omnicare when he stated, "negotiators may be able to navigate around this new hazard".[170] The point with all the newly crafted deal protection devices is to achieve an effective lock-up that is different enough from Omnicare's per se invalid absolute lock-up.[171] The basic rule is that deal protection devices are consistent with Omnicare when the board retains the power to allow the stockholders to accept a superior transaction.

A typical approach has been to include a meaningful fiduciary out clause in a merger agreement allowing the target board to exercise its fiduciary duties under all circumstances.[172] Usually this means that the agreement does not include a force to vote provision, but that the target board has a right to terminate the deal before it is closed if it receives a superior offer from another company.[173] An absence of force to vote provision does not necessarily weaken the lock-up if majority stockholders approve the merger by acting in consent. In case law, it has been interpreted that the board of the target company can retain an effective fiduciary out in the merger agreement and receive the majority shareholders' consent shortly after the board's approval.[174] This so-called sign-and-consent structure minimizes the window in which the target can receive a superior offer, and thus increases certainty for the bidder.

Another new effective device to ensure the shareholder acceptance of a merger agreement is making the large shareholder to agree to forego upside in the event of a topping deal.[175] This means that in the event of a superior bid, the shareholder have agreed to give up a large percentage, even 50% or more, of its potential profits.[176] The goal of an upside provision is to reduce large shareholders' incentive to seek an alternative bid. Its effect is obvious. An upside provision is only one example of many possible deal protection devices that are aimed at reducing the target company's and its shareholders' incentive to terminate the signed merger agreement. Many deal protection devices are crafted solely for making it expensive for the target company to abandon the signed deal.

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168 Davidoffa & Sauttera 2013 at 681–685.

169 Ibid. at 681.

170 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 946 (Veasey, C.J., dissenting) (Del 2003).

171 Davidoffa & Sauttera 2013 note 161 at 702.

172 Regner 2004 at 20.

173 Ibid.

174 Optima Int'l of Miami, Inc. v. WCI Steel, Inc., C.A. No. 3833-VCL at. 127; In re OPENLANE, No. 6849-VCN, 2011 WL 4599662 at 10.

175 Regner 2004 at 20.

176 Ibid.

# 5 CONCLUSIONS

Omnicare has not been overruled and remains good law, formally applicable. At the time of writing this Article, in March 2015, The Supreme Court of Delaware has not discussed Omnicare's applicability since deciding it. However, the Delaware Court of Chancery and courts outside of Delaware have indicated their willingness to limit Omnicare's reach. These courts have actually analyzed Omnicare like the dissenting Justices did. Courts have declined to apply the enhanced scrutiny standard to deal protection devices as suggested in Omnicare. In post-Omnicare case law, the Omnicare holding is constantly construed narrowly. As a result, the number of actual scenarios where Omnicare could still have a direct impact seems small.

In addition, it seems possible and easy to effectively lock-up a merger agreement by using deal protection devices different from those that were used in Omnicare. Deal protection devices are only contractual terms and creative lawyers have crafted plenty of new lock-ups since Omnicare. Upside provisions, meaningful fiduciary out clauses, and shareholders approving the deal by acting in consent, are all tools to effectively lock-up the deal without the target board breaching its fiduciary duties. In practice, merger agreements contain varying numbers of different deal protection devices that operate in concert to achieve effective lock-ups.

Due to the courts' narrow construction of Omnicare and practitioners' creative crafting of new deal protection devices, there is a good reason to believe that Omnicare has only limited applicability today.

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