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Corporate Governance Group

Client Alert

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DELAWARE CHANCERY COURT ENJOINS STANDSTILL AGREEMENT

"Don't Ask, Don't Waive" Provision Deemed to Impermissibly Limit the Board's On-Going Statutory and Fiduciary Obligations

In two separate telephonic rulings, the Delaware Chancery Court recently ruled in *In Re Complete Genomics, Inc. Shareholder Litigation*[1] that a "don't ask, don't waive" provision in a standstill agreement was an impermissible limitation on a director's "ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders." This decision once again reflects the importance that Delaware courts place on directors as fiduciaries and highlights that deference to independent boards supervising a sale process will only survive judicial scrutiny when deal protection devices are not deemed to represent "a promise by a fiduciary to violate its fiduciary duties".

Background

Complete Genomics is NASDAQ-listed company that, despite developing "a unique DNA sequencing technology", was unable to reach profitability. In light of receiving a going-concern qualification as of the date of its most recent year-end audited financial statements, Complete Genomics tried to raise capital in the first part of 2012. By May 2012, the Complete Genomics board determined to explore "all potential strategic alternatives available to the company" and formally engaged a financial advisor to assist with this process. On June 5, 2012, Complete Genomics "announced publicly that it was exploring strategic alternatives" and its advisors "reached out to 42 parties that might be interested in an equity investment or strategic partnership or acquisition". Of these 42 parties, nine parties executed confidentiality agreements, two of which contained "don't ask, don't waive" provisions that prohibited those bidders from making a non-public request to the Complete Genomics board to waive its standstill provision in order to potentially pursue a possible topping bid.

1 C.A. No. 7888-VCL (November 9, 2012 and November 27, 2012).

For further information about this Client Alert, please contact:

Roland Hlawaty
Partner
212-530-5735
rhlawaty@milbank.com

David Schwartz
Of Counsel
212-530-5260
dschwartz@milbank.com

You may also contact any member of Milbank's Corporate Governance Group. Contact information can be found at the end of this Client Alert. In addition, if you would like copies of our other Client Alerts, please visit our website at www.milbank.com and choose "Client Alerts" under "News."

After several months of negotiations with various parties, Complete Genomics narrowed its process down to pursuing a sale of the entire company. On September 15, 2012, Complete Genomics executed a merger agreement with BGI-Shenzhen, pursuant to which BGI would acquire Complete Genomics in a two-step transaction, valued at $3.15 per share in cash (a 54% premium over the trading price on June 4, 2012, the day before Complete Genomics publicly announced its intention to pursue all possible strategic alternatives).

Of note, the merger agreement did not "permit Genomics to terminate the transaction to accept a superior proposal." Accordingly, unless BGI breached the merger agreement, "Genomics only can terminate [the] agreement unilaterally if [BGI] fails to complete its offer".....leaving "Genomics irrevocably committed to the transaction until March 14, 2013", the outside termination date.

Analysis

The plaintiffs alleged that (i) the "don't ask, don't waive" standstill provisions in the two confidentiality agreements represented an "improper impediment"…on "a potential bid for the company" and (ii) under a *Revlon*[2] analysis, "the merger agreement is preclusive or coercive because the Genomics board cannot terminate the merger agreement to accept a superior proposal...".

Beginning with the "don't ask, don't waive" standstill provisions, the Court expressed its view that such a provision essentially breaches a director's fiduciary duty of candor because a board has "an ongoing statutory and fiduciary obligation to provide a current, candid and accurate merger recommendation." While "a board doesn't necessarily have an obligation to negotiate" with third parties after executing a merger agreement, "'directors cannot willfully blind themselves to opportunities that are presented to them" by disabling themselves "from engaging in dialogue with a potential acquirer under any circumstances whatsoever". In the Court's view, taking such action would be "the legal equivalent of willful blindness", and as a result, in violation of Delaware law requiring "that a board of directors give a meaningful, current recommendation to stockholders regarding the advisability of a merger including, if necessary, recommending against the merger as a result of subsequent events." The Court further elaborated, holding that "don't ask, don't waive" standstill provisions impermissibly "interfere with the target's ability to determine whether to change its merger recommendation because they absolutely preclude the flow of incoming information to the board", and therefore "limited [the Genomic's board's] ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders." Put another way, such a provision "represents a promise by a fiduciary to violate its fiduciary duty, or represents a promise that tends to induce such a violation". As a result of the foregoing, the Court held that the "don't ask, don't waive" provision creates irreparable harm to the plaintiffs because any incoming information from a third party bound by such a provision is "flat-out" prohibited under any circumstances (absence a "cavalier" breach by that third party of its confidentiality agreement), and therefore, there would be no way ever of knowing whether such third party "would ever want to make some type of bid or other acquisition proposal".

While the targeted injunction of the "don't ask, don't waive" was the noteworthy decision in Complete Genomics, the Court's analysis of the merger agreement provisions under a *Revlon* analysis

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

was also quite significant. To begin this prong of its analysis, the Court noted that "[w]hen a board has informed itself thoroughly, it can enter into an exclusive merger agreement". The Court stated that the merger agreement was not preclusive because as "*Revlon* teaches, deal protection measures are wrongfully preclusive if they effectively preclude bidders from competing with the favored bidder. Here, a competing bidder could commit publicly to a tender offer for any and all of Genomics' shares to be followed by a back-end merger at the same offered price…Because of that ability, there is a realistic path for stockholders to receive an alternative bid." Moreover, as the Court parsed through the other deal protection devices in the merger agreement, the Court noted that the agreement did "not require the payment of a termination fee if stockholders simply decline to tender and the minimum condition [was] not met by the outside date" but rather only required "the payment of a termination fee if the minimum condition [was] not met by the outside date and a topping bid [had] emerged, or the board [had] failed to maintain its recommendation in favor of the merger agreement…". Accordingly, "Genomics [could] freely choose the status quo without penalty."

Further elaborating, the Court stated that "'Delaware entities are free to enter into binding contracts without a fiduciary out so long as there is no breach of fiduciary duty involved when entering into the contract in the first place'", and that target company directors "are not free to terminate an otherwise binding merger agreement just because they are fiduciaries and circumstances have changed". Accordingly, following the open and public auction process conducted by Complete Genomics, the Court was not willing to then second guess the board's decision to execute a merger agreement that limited its ability going forward to seek a transaction that could result in a superior proposal. Supporting the Court's analysis was the fact that the Genomics' stockholders were still empowered to "reject the transaction and maintain the status quo" by voting against the BGI transaction, despite the "negative consequences to continuing with the status quo…". But, in the Court's analysis, "neither the existence of those negative consequences nor accurate disclosures about them constitutes wrongful coercion" of the stockholder vote. Put another way, the Court noted that if "all that defendants have done is to create an option for shareholders, then it can hardly be thought to have breached a duty."

Conclusion

The *Complete Genomics* decision provides useful insight into when a court will defer to independent boards who diligently supervise a sale process. Key to this deference is whether or not a target company board impermissibly precludes itself from considering all available information, making it unable to make a meaningful recommendation to its stockholders regarding the transaction at hand.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

Beijing
Units 05-06, 15th Floor, Tower 2
China Central Place, 79 Jianguo Road, Chaoyang District
Beijing 100025, China

Anthony Root	+86-10-5969-2777	aroot@milbank.com
Edward Sun	+86-10-5969-2772	esun@milbank.com
Gary Wigmore	+86-10-5969-2769	gwigmore@milbank.com

Frankfurt
Taunusanlage 15
60325 Frankfurt am Main, Germany

Norbert Rieger	+49-89-25559-3620	nrieger@milbank.com

Hong Kong
3007 Alexandra House, 18 Chater Road
Central, Hong Kong

Anthony Root	+852-2971-4842	aroot@milbank.com
Gary Wigmore	+852-2971-8815	gwigmore@milbank.com
Joshua Zimmerman	+852-2971-4811	jzimmerman@milbank.com

London
10 Gresham Street
London EC2V 7JD, England

Stuart Harray	+44-20-7615-3083	sharray@milbank.com

Los Angeles
601 South Figueroa Street, 30th Floor
Los Angeles, CA 90017

Ken Baronsky	+1-213-892-4333	kbaronsky@milbank.com
Neil Wertlieb	+1-213-892-4410	nwertlieb@milbank.com

Munich
Maximilianstrasse 15 (Maximilianhöfe)
80539 Munich, Germany

Peter Nussbaum	+49-89-25559-3430	pnussbaum@milbank.com

New York
One Chase Manhattan Plaza
New York, NY 10005

Scott Edelman	+1-212-530-5149	sedelman@milbank.com
Roland Hlawaty	+1-212-530-5735	rhlawaty@milbank.com
Thomas Janson	+1-212-530-5921	tjanson@milbank.com
Joel Krasnow	+1-212-530-5681	jkrasnow@milbank.com
Alan Stone	+1-212-530-5285	astone@milbank.com
Douglas Tanner	+1-212-530-5505	dtanner@milbank.com
Paul Wessel	+1-212-530-5077	pwessel@milbank.com

São Paulo
Rua Colombia, 325
Jardim América
São Paulo, SP
01438-000

Andrew Janszky	+55-11-3927 7701	ajanszky@milbank.com

Singapore
30 Raffles Place, #14-00 Chevron House
Singapore 048622

David Zemans	+65-6428-2555	dzemans@milbank.com
Naomi Ishikawa	+65-6428-2525	nishikawa@milbank.com

Tokyo
21F Midtown Tower, 9-7-1 Akasaka, Minato-ku
Tokyo 107-6221 Japan
+813-5410-2801

Washington, DC
International Square Building, 1850 K Street, NW
Suite 1100
Washington, DC 20006

Glenn Gerstell	+1-202-835-7585	gerstell@milbank.com