

Delaware Court Refuses To Dismiss Breach Of Contract And Fraud Claims By Jilted Merger Partner

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Indicates That Acquirer's Pre-Closing Operational Control May Create Fiduciary Relationship Sufficient to Support Fraud Claim

A decision of the Delaware Court of Chancery in late 2010, *Narrowstep, Inc. v. Onstream Media Corp.*, [\[1\]](#) demonstrates the unintended consequences that can befall a merger partner who uses superior bargaining power to achieve unusual contractual rights. Pursuant to their Merger Agreement, Narrowstep agreed to yield operational control of its business to Onstream, *prior to closing*, in order to accelerate integration of the businesses. Despite negotiating multiple delays and purchase price reductions, Onstream chose to terminate the Merger Agreement rather than close the transaction.

In response, Narrowstep filed a complaint alleging breach of contract and fraud on the part of Onstream. The Court rejected Onstream's motion to dismiss these claims, finding that Narrowstep's description of the dealings between the two companies - including the unusual and significant degree of control exercised by Onstream over Narrowstep's business under the Merger Agreement - was sufficient not only to plausibly suggest that Onstream breached its obligations under the Merger Agreement, but also to state a claim that Onstream engaged in fraudulent misconduct.

Background

Narrowstep provides internet TV services and supports content providers, broadcasters and telecommunications companies worldwide. Beginning in late 2007, Narrowstep sought to sell itself to potential acquirers in the internet TV industry. To that end, in early 2008, Narrowstep granted Onstream full access to conduct due diligence.

On May 29, 2008, Narrowstep and Onstream entered into a Merger Agreement. Unlike the typical arrangement, the Merger Agreement required Narrowstep to "effectively cede[] operational control of its business" to Onstream *prior to* the closing of the transaction "in order to create immediate synergies and cost savings." An agreed upon integration plan required that Narrowstep, among other things, terminate certain employees and leases, assimilate Onstream personnel into its business and relocate its equipment to Onstream facilities. [\[2\]](#)

To say the least, the pre-closing process did not go smoothly from Narrowstep's point of view. First, Onstream expressed concerns that Narrowstep was losing large customers and that others were not timely paying their bills. Fearing that the integration process "had undermined its ability to operate independently," Narrowstep felt compelled to accede to Onstream's demand for a purchase price reduction and an extension of the outside date for closing. Shortly thereafter, Onstream raised additional concerns regarding the status of contracts with two other significant Narrowstep customers. Concluding that "unwinding the Integration process would be costlier than agreeing to Onstream's desired price

concessions," Narrowstep agreed to a second purchase price reduction. Then, later in the year, Onstream sought yet another price reduction, but this time Narrowstep refused.

Finally, on March 18, 2009, with the merger still pending but the November 30, 2008 outside date for closing having passed, Onstream exercised its right to terminate the Merger Agreement. In response, Narrowstep brought suit alleging that, among other things, Onstream breached its obligations under the Merger Agreement and committed fraud. According to Narrowstep's complaint, "the Integration process and numerous closing delays weakened its operational and financial position," causing it to suffer "millions of dollars in damages." Onstream in turn asked the Court to dismiss these claims.

The Court's Analysis

Breach of Contract

Narrowstep asserted that Onstream breached the Merger Agreement "by failing to use its reasonable best efforts" to (i) timely file a registration statement with the Securities and Exchange Commission in connection with the merger or (ii) take necessary actions to close the merger. To support these claims, Narrowstep charged that Onstream "manufactured numerous delays in the Integration process" and raised a variety of concerns about matters previously disclosed to Onstream when it conducted due diligence. Narrowstep also claimed that Onstream used "stall tactics" that "caused significant delays," and then refused to close the transaction unless and until it had been granted purchase price reductions. Finally, Narrowstep alleged that Onstream improperly terminated the Merger Agreement, even though the agreement denied termination rights to any party whose failure "to perform any of its obligations" caused the merger not to close by the outside date.

The Court denied Onstream's motion to dismiss on the basis that Narrowstep's complaint "alleges sufficient facts plausibly to suggest that Onstream did not use its reasonable best efforts to file the Statement by the prescribed date and, instead, deliberately took actions to delay its filing." ^[3] More broadly, the Court concluded that Narrowstep "sufficiently alleged facts that, if true, support a reasonable inference that Onstream failed to take all steps necessary to consummate the merger expeditiously" and, in fact, "did the opposite and may have stalled the process deliberately and in bad faith." And, with respect to Narrowstep's damages claim, the Court found that Narrowstep sufficiently alleged that the "frequent and significant" delays caused by Onstream's alleged breaches "enabled Onstream to plunder Narrowstep during the Integration period, effectively rendering it unable to operate as a profitable and independent company." ^[4]

Fraud

Common Law Fraud. The Court also refused to dismiss Narrowstep's common law fraud claim against Onstream. The Court began its analysis of this claim by explaining that "[t]o state a claim for common law fraud, a plaintiff must allege: '(1) that a defendant made a false representation, usually one of fact; (2) with the knowledge or belief that the representation was false, or with reckless indifference to the truth; (3) with an intent to induce the plaintiff to act or refrain from acting; (4) that plaintiff's action or inaction was taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of her reliance on the representation.'"

In support of its fraud claim, Narrowstep alleged that Onstream "constructed the [Merger] Agreement so that it immediately would gain operational control... and, in so doing,

imposed a series of stringent conditions that effectively prevented Narrowstep from continuing to operate as an independent company." Once Narrowstep became dependent on Onstream, Narrowstep claimed, "Onstream began manufacturing a series of excuses and 'concerns' which delayed the merger closing," and then "used these concerns to extract concessions as to price and other terms from a much weakened Narrowstep." As a result of this pattern of activity, Narrowstep contended that "it had virtually no choice but to rely on Onstream's continual reassurances that a closing was imminent... [and consequently] lost millions of dollars." With the benefit of 20x20 hindsight, Narrowstep claimed that Onstream's "reassurances" constituted nothing more than "false representations" as to Onstream's desire to close the merger in an expeditious manner. In the Court's view, these claims were sufficient, at least at the pleading stage, to warrant denial of Onstream's motion to dismiss Narrowstep's allegations of fraud.

Equitable Fraud. The Court also ruled that because Narrowstep met the pleading requirements for a common law fraud claim, by definition it also sufficiently pled equitable fraud. The Court explained that the elements of equitable fraud are the same as those for common law fraud, except that a plaintiff need not plead intent or knowledge of wrongdoing. Rather, a plaintiff claiming equitable fraud "must sufficiently plead a special relationship between the parties or other special equities, such as some form of fiduciary relationship."

The Court determined that Narrowstep satisfied this pleading requirement because "[w]hat began as arms-length commercial bargaining between the parties transitioned into Onstream controlling Narrowstep for all intents and purposes... even before the merger closed." In fact, while "this Court is reluctant to extend the 'exacting standards of fiduciary duties... to... commercial relationships,' the parties' relationship under the [Merger] Agreement and the [integration] Plan exhibits many of the factual indicia usually associated with fiduciary dealings."

Conclusion

The Court of Chancery's decision in *Narrowstep* offers a cautionary tale to any acquirer who leverages superior bargaining power to secure stronger contractual rights than might typically be available. Surely Onstream viewed its ability to obtain operational control of Narrowstep's business prior to closing as a home run, and took advantage of its increasingly stronger position by demanding - and obtaining - price reductions and closing delays. However, this negotiating success seemingly backfired on Onstream when it attempted to terminate the transaction but was unsuccessful in winning dismissal of Narrowstep's breach of contract and fraud claims. While a trial on the merits might yield a different result, the loss of a motion to dismiss can seriously diminish a plaintiff's bargaining leverage in any settlement talks.

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^[1] C.A. No. 5114-VCP (Del. Ch. Dec. 22, 2010).

^[2] It should be noted that such controls would not be permissible in a transaction of a size requiring a pre-merger notification filing and review under the Hart-Scott-Rodino Antitrust Act of 1976, until termination or expiration of the applicable waiting period.

^[3] Although the Merger Agreement did not initially specify a filing deadline for the registration statement, the second amendment provided that "[Onstream] shall use its reasonable best efforts to cause the Registration Statement to be filed on or before September 18, 2008..." In fact the registration statement was not filed until September 23rd, but Onstream argued that September 19th was a "soft deadline" because the parties agreed only that Onstream would use its "reasonable best efforts" to file by that date. Onstream also contended that the obligation to file the registration statement was intended to be joint and cooperative, not solely that of Onstream. The Court did not accept either of these arguments.

^[4] In contrast, the Court did grant Onstream's motion to dismiss Narrowstep's claim that Onstream breached the implied covenant of good faith and fair dealing. In this connection, the Court recognized that Narrowstep was alleging merely that Onstream acted in bad faith in connection with its breach of express terms of the Merger Agreement. The Court refused to allow Narrowstep to "state a separate claim for a breach of an implied term that would proscribe the same behavior as" an express provision of the Merger Agreement.

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