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# Corporate Governance Group

# Client Alert

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## DELAWARE COURT DELAYS SHAREHOLDERS MEETING CALLED TO APPROVE MERGER PENDING DISTRIBUTION OF ENHANCED DISCLOSURES

*While dismissing challenge to board process, Court criticizes disclosures of financial advisor compensation and post-closing employment opportunities for target CEO*

Recently, in *In re Atheros Communications, Inc. Shareholders Litigation*,<sup>1</sup> the Delaware Court of Chancery provided guidance on the sufficiency of proxy statement disclosures of a variety of merger-related topics, including contingent compensation payable to a target company's financial advisor and employment opportunities offered by an acquirer to the target company's CEO. Although the Court did not find fault with the process followed by the target board – including a grant of exclusivity to an attractive, but contingent, bidder – it nonetheless delayed the shareholders meeting called to approve the transaction until enhanced proxy statement disclosures could be distributed to target company shareholders.

### **Background**

Atheros Communications, Inc. designs solutions for wireless and wired communications products. In March 2010, Atheros began discussing its possible acquisition by Qualcomm Incorporated, a wireless telecommunications company. Atheros's board retained Qatalyst Partners LP, which was well known to the board and "recognized [for] its expertise in the semiconductor industry," to serve as its financial advisor and provide a fairness opinion. The engagement letter with Qatalyst, signed in December 2010, provided Qatalyst with a flat fee, approximately 98% of which was contingent upon closing of the transaction.

Discussions between the parties continued throughout much of 2010, with Atheros's management providing updates to the board at frequent special meetings. Finally, in

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<sup>1</sup> C.A. No. 6124-VCN (Del. Ch. March 4, 2011).

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November, Qualcomm submitted an all-cash offer, subject to completion of due diligence. Atheros responded with a counteroffer, which Qualcomm rejected as outside the range it was willing to consider. At a special meeting held on December 1st, Atheros's board analyzed a list of 11 potential acquirers suggested by Qatalyst, including Qualcomm. The board authorized Qatalyst to approach three of these companies – Qualcomm and two others, identified as Company A and Company B – and to seek information from a fourth, identified as Company C. Company A responded that it needed more time to consider a possible transaction, Company B indicated that it was not interested, and the board determined that Company C was unlikely to participate because it had not previously engaged in a transaction of comparable scale.

On December 6th, Qualcomm increased its offer price (but not to the level of Atheros's counteroffer), conditioned on completion of due diligence and the grant of exclusivity. Then, on December 8th, Company A requested a meeting with Atheros. At this meeting, Atheros management, while making largely the same presentation as it had given to Qualcomm, advised Company A that "Atheros was imminently entering into an exclusivity agreement."

Qualcomm continued to press for exclusivity and, on December 11th, the Atheros board concluded that "a significant risk existed that Qualcomm might abandon any transaction with Atheros in the absence of exclusivity" and "unanimously authorized the Company to enter into an agreement of that sort with Qualcomm." At that time, "Company A 'had not made an offer ... or indicated on what timeline, if any, it might make such an offer.'" An exclusivity agreement was signed the next day.

During the next several weeks, Qualcomm conducted due diligence as the parties negotiated the terms of the transaction. On January 4, 2011, following receipt of Qatalyst's opinion that the \$45 per share price (representing an approximate 21% premium over the closing market price before rumors of the transaction became public) being offered by Qualcomm was fair, the board unanimously approved a merger agreement with Qualcomm. Subsequently, Atheros distributed proxy materials to its shareholders seeking approval of the transaction.

Plaintiffs, purporting to act on behalf of all Atheros shareholders, brought a class action lawsuit seeking to preliminarily enjoin the shareholder vote on the grounds that the board breached its fiduciary duties by (1) implementing an inadequate sales process, and (2) seeking shareholder approval by means of a proxy statement containing several material omissions.

### *The Court's Analysis*

The Court explained that, to obtain the "extraordinary remedy" of a preliminary injunction, plaintiffs must show (i) a "reasonable probability" of success on the merits, (ii) that they will suffer "imminent, irreparable harm" if an injunction is not granted, and (iii) that the potential harm from failing to grant an injunction outweighs the potential harm that granting the injunction could cause.

## Probability of Success

### *Price and Process Claims*

Because the challenged transaction involved the potential change in control of Atheros, the Court invoked the familiar *Revlon*<sup>2</sup> standard. *Revlon* requires the Court to determine whether the board satisfied its “obligation to secure the best value reasonably attainable for its shareholders . . . .” According to *Revlon* and its progeny, a board need not follow a single path, but rather, the Court must decide “whether the directors made a reasonable decision, not a perfect decision.”<sup>3</sup>

“Here,” the Court noted, “the record indicates no basis to question the Board’s good-faith desire to maximize shareholder value.” To support this finding, the Court cited the facts that seven of the eight directors were “disinterested and independent”; the board “took an active role at an early point in the lengthy sales process” and “deliberated on the Company’s strategic alternatives throughout the process, including the potential for other suitors to offer a higher price”; the board “demonstrated its willingness to discuss a sale with other serious acquirors”; and the “robust process resulted in extensive negotiations with Qualcomm and netted a significantly higher offer” than was initially proposed.

With respect to the decision to grant Qualcomm exclusivity, the Court found that “the Board made a reasonable judgment to pursue Qualcomm’s definite offer – which was conditioned on exclusivity – instead of continuing discussions with Company A at the risk of Qualcomm abandoning any transaction altogether.” If Company A had “wished to be heard it could have expressed an interest, before, or even after, Atheros entered into the exclusivity agreement; all indications are that the Board would have listened.”

Finally, the Court rejected plaintiffs’ challenge to the deal protection devices included in the merger agreement, namely a “no solicitation clause,” a “matching rights provision,” and a termination fee “which represents approximately 3.3% of the total value of the Transaction.” The Court characterized these as “standard merger terms . . . not *per se* unreasonable.”

### *Disclosure Claims*

The Court explained that “when soliciting stockholder action, the directors of a Delaware corporation are bound by their fiduciary duties of care and loyalty to ‘disclose fully and fairly all material information within the board’s control . . . .’” Thus, “[n]on-material facts need not be disclosed, but once a board voluntarily makes a partial disclosure, it has ‘an obligation to provide the stockholders with an accurate, full, and fair characterization’ of the facts relating to that partial disclosure.” Against this backdrop, the Court analyzed plaintiffs’ four disclosure claims, agreeing with two and rejecting two others.

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<sup>2</sup> *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173 (Del. 1986).

<sup>3</sup> In this regard, the Court cited its recent decisions in *In re Dollar Thrifty S’holder Litig.*, 2010 W.L. 5648895 (Del. Ch. September 8, 2010), and *In re Cogent, S’holder Litig.*, 7 A.3d 487 (Del. Ch. 2010). For a discussion of the *Dollar Thrifty* decision, see our Client Alert entitled “Delaware Court Refuses to Enjoin Dollar Thrifty Merger with Hertz,” dated October 12, 2010. For a discussion of the *Cogent* decision, see our Client Alert entitled “Delaware Court Refuses to Enjoin 3M Tender Offer for Cogent,” dated November 15, 2010.

### *Compensation of Financial Advisor*

When shareholders voting on a sale transaction are asked to consider a fairness opinion, “the conflicts and arguably perverse incentives that may influence the financial advisor in the exercise of its judgment and discretion must be fully and, fairly disclosed.” Atheros’s proxy statement “informed shareholders that Qatalyst would ‘be paid a customary fee, a portion of which is payable in connection with the rendering of its opinion and a substantial portion of which will be paid upon completion of the Merger,’” Not disclosed, however, was the actual amount of Qatalyst’s prospective compensation. “Perhaps more importantly,” the Court noted, “also not disclosed in the Proxy Statement is a qualification of the amount of the fee that is contingent: approximately ninety-eight percent.” In the Court’s view, such a large contingency “exceeds both common practice and common understanding of what constitutes ‘substantial’” and, “[i]n essence, the contingent fee can readily be seen as providing an extraordinary incentive for Qatalyst to support the Transaction to support the Transaction.”

The Court did clarify that it was not implying that contingent fees are illegitimate or that Qatalyst acted improperly, but rather “simply observ[ing] that the incentives are so great that the stockholders should be made aware of them and that this contingent fee structure is material to their decision.” Further, the Court emphasized that fixing a bright-line rule for what constitutes a “substantial” contingent fee is difficult, but noted that “[r]egardless of where that ‘line’ may fall, it is clear that an approximately 50:1 contingency ratio requires disclosure to generate an informed judgment by the shareholders . . . .”

### *Methodology Employed by Financial Advisor*

Plaintiffs argued that, in addition to employing a valuation methodology based on Wall Street analyst research, Qatalyst should have generated a valuation based on Atheros’s own internal projections. According to plaintiffs, this would have led to a significantly higher per share value of \$64. The Court disagreed, noting that “[t]he Board provided Atheros’s internal projections to Qatalyst; Qatalyst decided that, under the methodology it employed, the internal projections were not useful because they would not allow for an ‘apples to apples’ comparison with the information available for comparable transactions.” Ultimately, the Court concluded, “quibbles with a financial advisor’s work simply cannot be the basis of a disclosure claim.”

### *Barratt’s Prospective Employment with Qualcomm*

Plaintiffs contended that the potential future employment of Atheros CEO Craig Barrett (who also served on the Atheros board) with Qualcomm “could have influenced him, in his role as Atheros’s lead negotiator, to take a less aggressive stance on behalf of its stockholders.” Moreover, they argued, the assertion in the proxy statement that, “before December 14, 2010, ‘Dr. Barratt had not had any discussions with Qualcomm regarding the terms of his potential employment by Qualcomm’” was misleading. Atheros did not dispute that Barratt understood, some time before December 14th, that “he would have a job at Qualcomm,” but characterized all communications prior to that date as “initial exploratory discussions” not requiring disclosure.

While characterizing the language of the proxy statement as “perhaps ambiguous enough to support” Atheros’s position, the Court concluded that “the record indicates that, as of a date earlier than December 14, 2010, Barratt had overwhelming reason to believe he would be employed at Qualcomm after the Transaction closed.” In fact, the proxy statement’s “robust disclosures regarding the terms of Barratt’s post-closing employment . . . dispel any notion that Barratt had no expectations . . . regarding how he would be treated by Qualcomm.”

In the Court's view, "[b]ecause the Proxy Statement partially addressed the process by which Barratt negotiated his future employment with Qualcomm, the Board must provide a full and fair characterization of that process." Thus, inasmuch as Barratt was aware, while he was negotiating the transaction on behalf of Atheros, that he would receive an offer of employment from Qualcomm, "the date on which Barratt learned from Qualcomm that it intended to employ him after the Transaction closed should be disclosed."

### *Negotiations Over the Offer Price*

Finally, plaintiffs contended that the proxy statement should have disclosed the specific prices proposed by Atheros and Qualcomm, respectively, during their negotiations. The Court disagreed, noting that "Delaware law does not require Atheros to 'give its shareholders a play-by-play description of merger negotiations.' ... [T]he rejected proposals of each side are not material ... where there has been no competitive bidding process and there is, therefore, nothing to compare the various offers and counteroffers against." Presumably the result would have been different had another serious bidder emerged.

### **Irreparable Harm**

Having determined that Atheros's disclosures regarding Qatalyst's compensation and Barratt's post-closing employment with Qualcomm were deficient, the Court next analyzed the extent to which these deficiencies would cause irreparable harm to Atheros shareholders. The Court emphasized that "financial advisors serve a critical function by providing fairness opinions regarding the valuation of an enterprise, and, here, Atheros asks its shareholders to rely upon the fairness opinion Qatalyst has provided; the shareholders, therefore, have the right to disclosure of material facts that might provide reason to question the reliability of that opinion." Similarly, the Court determined that "[t]he omission of the fact that Barratt knew, as of a date earlier than December 14, 2010, that he would be employed by Qualcomm after closing is material ... ." On this basis, the Court determined that the element of irreparable harm had been established.

### **Balancing the Equities**

Finally, the Court concluded that "[i]n light of the paramount importance of enabling the shareholders to make fully informed decisions regarding the Transaction and the comparatively low risk that the eventual completion of the Transaction would be threatened by a short delay of the shareholder vote, the equities favor enjoining the shareholder vote until the disclosures necessary to remedy the deficiencies in the Proxy Statement can be made." The Court was careful to note, however, that "any extended delay, as would be necessary if Atheros were to be required to restart the sales process, for example, could potentially put the Transaction at some risk (e.g., that Qualcomm would walk away from the deal, thus denying the shareholders the premium provided in the offer price) without providing any assurance that another suitor would emerge to offer shareholders a better deal than they will receive under the Transaction." Accordingly, the Court stipulated that its preliminary injunction "may be lifted following appropriate distribution of the curative disclosures ... ."

### *Conclusion*

The Court's ruling in *Atheros* underscores that "once a board voluntarily makes a partial disclosure, it has 'an obligation to provide the stockholders with an accurate, full, and fair characterization' of the facts relating to that partial disclosure." While Delaware courts are reluctant to set aside, or even significantly delay, transactions that seem favorable to shareholders and are not subject to outstanding competing bids or serious conflict of interest claims, they are prepared to provide more limited remedies in the face of shortcomings in disclosures that could impact a shareholder vote.

The decision also emphasizes the importance attributed to disclosures regarding potential conflicts of interest that could impact the fairness of the process. Although contingent financial advisor fees are customary in change of control transactions, and potential success fees generally far outweigh the fee for the fairness opinion, Delaware courts will nonetheless carefully scrutinize the completeness and adequacy of disclosures of financial advisor compensation. Similarly, Delaware courts are wary of potential management conflicts in change of control transactions that could negatively impact the bidding process. Not only must these potential conflicts be limited and scrupulously managed, but the related disclosures must be completely forthcoming.

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