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Corporate Governance Group

Client Alert

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DELAWARE COURT RULES THAT NON-SIGNATORY SHAREHOLDERS ARE BOUND BY TERMS OF MERGER AGREEMENT

Decision provides flexibility in structuring acquisitions of private companies with numerous minority shareholders

Companies controlled by private equity funds or venture capitalists often have a significant number of minority shareholders. Typically, these minority shareholders are employees and/or "friends and family" of the controlling shareholders and members of management. As a result, M&A practitioners and their clients are presented with significant logistical issues in structuring and documenting acquisitions of these companies. Statutory mergers are usually employed to address these complexities, because under state law only the controlling shareholders are needed to vote on the transaction.[1] There has been some uncertainty, however, as to the binding effect of various provisions of the merger documentation on shareholders who are neither asked to sign the document nor to vote on the merger.

This issue recently came before the Delaware Court of Chancery in *Aveta Inc. v. Cavallieri*.[2] In *Aveta,* the Court was asked to consider whether the "contractual process for calculating the consideration" payable in a merger, including a post-closing adjustment negotiated on behalf of former shareholders by a "shareholders' representative" appointed in the merger agreement, binds those shareholders. In ruling that both the controlling shareholders, who signed the merger agreement, and the non-controlling shareholders, who did not, are subject to the terms of the merger agreement, the Court clarified an area that has caused some angst among M&A practitioners.

[1] Although dissenting minority shareholders do have the right to assert statutory appraisal rights.

[2] C.A. No. 5074-VCL (Del. Ch. Sept. 20, 2010).

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Background

Preferred Medicare Choice Inc. ("PMC") is a Puerto Rico corporation that "operates a provider network of doctors and other health professionals on the island." Prior to its 2006 acquisition by Aveta Inc., a "health insurance company that specializes in building provider networks and management service organizations," PMC had two classes of stock: Class A, comprising 51% of its outstanding shares, and Class B, comprising 49% of its outstanding shares. The Class A shares were owned by a control group of four individuals, including Roberto L. Bengoa. The Class B shares were owned by over 100 individuals, many of whom were providers in PMC's network.

Aveta completed its acquisition of PMC in a two-step transaction governed by an Agreement and Plan of Merger and Stock Purchase entered into by Aveta, PMC and the Class A shareholders ("Merger Agreement"). In the first step, Aveta purchased the Class A sharees from the Class A shareholders for cash. In the second step, a newly-formed Puerto Rico acquisition company owned by Aveta was merged into PMC. As a result of this merger, PMC became a wholly-owned subsidiary of Aveta and the Class B shares were converted into cash. Because the votes of the Class A shareholders were sufficient to approve the merger, none of the Class B shareholders was asked to become a party to the Merger Agreement or to vote on the merger.

The Merger Agreement provided for an aggregate cash purchase price of $157 million, 60.93% of which was allocated to the Class A shareholders and 39.07% of which was allocated to the Class B shareholders. The purchase price was subject to post-closing adjustment based on calculations set forth in the Merger Agreement. Aveta was responsible for calculating the post-closing adjustment following an examination of PMC's books and records and then providing that calculation to Bengoa, who was appointed under the terms of the Merger Agreement to act as "Shareholders' Representative" for *all* PMC shareholders. In that capacity, Bengoa was authorized to negotiate the adjustment with Aveta. If Aveta and Bengoa could not agree, their dispute would be resolved through binding arbitration by Ernst & Young LLP.

After the transaction closed, Aveta and Bengoa were unable to reach agreement on the post-closing adjustment proposed by Aveta. After nearly a year of unsuccessful negotiations, Aveta commenced an arbitration with E&Y. Bengoa, however, refused to participate. Meanwhile, a group of former Class B shareholders "purported to revoke Bengoa's designation" as Shareholders' Representative, claiming he had "no authority to represent them." In response to these developments, Aveta filed suit against the former PMC shareholders, seeking to resolve the "central question" as to "whether the contractual process [included in the Merger Agreement] for calculating the consideration, including the outcome of the E&Y arbitration, binds all former PMC shareholders." Both sides subsequently moved for summary judgment.

The Court's Analysis

The Court began by noting that the parties to the Merger Agreement had "opted for their obligations to be governed by a mixture of Delaware and Puerto Rico law." In the case of issues arising under the Merger Agreement "as to its contractual terms," Delaware law was controlling. However, because the second step merger was "between two Puerto Rico corporations," the internal affairs doctrine required that the "implementation and effectiveness" of the merger was governed by Puerto Rico law. Against this backdrop, the Court next turned to an analysis of the binding effect of the post-closing adjustment provisions of the Merger Agreement on the two classes of former PMC shareholders.

Class A Shareholders

Invoking the principles of Delaware agency law, the Court ruled that the Class A shareholders "are bound by Bengoa's actions because they irrevocably appointed Bengoa as their agent" when they signed the Merger Agreement. The irrevocability of the appointment depended on whether it was "coupled with an interest." The Court explained that an agency appointment is coupled with an interest if, among other attributes, the "recipient of the power … possess[es] authority over or an interest in the subject matter of the agency that exists independent of the agency relationship." Because Bengoa was a member of the group that controlled PMC, the Court determined that this status "gave him standing to enforce a right to his share of the Transaction Consideration independent of the grant of authority" to him as Shareholders' Representative under the Merger Agreement. Accordingly, his authority as Shareholders' Representative "was coupled with an interest sufficient to make it irrevocable."

As an alternative basis for validating the grant of irrevocable authority to Bengoa, the Court applied the principle of "reliance." In this regard, the Court noted that the Merger Agreement was "a binding legal agreement" under which "Aveta bargained for the right to rely" on Bengoa's appointment as Shareholders' Representative rather than having to negotiate individually with each Class A shareholder. Ultimately, in the Court's view, the relationship between the Class A shareholders and Bengoa "went beyond a basic principal-agent relationship and implicated Aveta's reliance interests."

On this basis, the Court determined that by signing the Merger Agreement, the Class A shareholders "irrevocably granted Bengoa authority to act as the Shareholders' Representative," an authority that "[t]hey could not later revoke … ."

Class B Shareholders

As for the binding effect on the Class B shareholders (who neither signed the Merger Agreement nor voted in favor of the merger) of the post-closing adjustment mechanism included in the Merger Agreement, the Court looked to the Puerto Rico General Corporation Law as in effect at the time of the merger. Section 3051(b) of that statute, which paralleled Section 251 of the Delaware General Corporation Law as it existed at that time, provided that "[a]ny of the terms of the agreement of merger or consolidation may depend upon facts ascertainable outside of such agreement; provided that the manner in which such facts shall affect the terms of the agreement, is clearly and expressly set forth in the agreement of merger or consolidation."[3]

After a thorough analysis of the legislative history of both statutes and applicable case law, the Court concluded that the post-closing adjustment provisions included in the Merger Agreement "easily qualify as provisions dependent on 'facts ascertainable outside of the merger agreement'" within the meaning of the Puerto Rico statute. In support of this conclusion, the Court pointed out that the adjustment mechanisms "turn on financial figures from PMC's books and records, including its audited financial statements. The methods for deriving those amounts are 'clearly and expressly set forth in the agreement of merger.'" Moreover, the Court noted that such procedures are not "impermissibly vague" nor do they "constitute an improper abdication, or otherwise give rise to a breach of fiduciary duty." On the contrary, the Merger Agreement "establishes formulas and procedures … [that] must be followed."

[3] The Court also pointed out that both the Puerto Rico and Delaware corporate statutes have been updated to make it even clearer that pricing formulas such as that employed in the Merger Agreement are enforceable.

Accordingly, even though the Class B shareholders were not signatories to the Merger Agreement and therefore had no agency relationship with Bengoa, the Court found that Puerto Rico corporate law dictates that "the Class B shareholders held shares that were converted by merger into the right to receive the Transaction Consideration as determined in accordance with" the Merger Agreement. These shareholders were, therefore, bound by the terms of the Merger Agreement, including the determinations made in connection with the post-closing adjustment. Simply stated, because the post-closing adjustment provisions "draw their power from Section 3051(b) as a matter of corporate law, no grant of agency authority was needed."

Conclusion

In granting Aveta's motion for summary judgment, the Court provided much needed clarity that will aid M&A practitioners in structuring acquisitions of private companies with a large number of minority shareholders. Based on *Aveta*, a shareholders' representative may be appointed by the merger agreement to act on behalf of the minority shareholders – even though they haven't signed the agreement or voted for the transaction – on such matters as post-closing purchase price adjustments, earn-outs, indemnity claims and other matters that cannot be defined with specificity in the agreement or are subject to future contingencies. This will provide significant flexibility in structuring and documenting these transactions.

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