October 27, 2010

Corporate Governance Group
Client Alert

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DELAWARE COURT AWARDS DAMAGES FOR SELLER'S BREACH OF EXCLUSIVITY COVENANT IN PURCHASE AGREEMENT

Rejects Argument That Fiduciary Duties Purportedly Owed to Creditors Negate Exclusive Dealing Arrangement

Outside the bankruptcy context, no prospective purchaser of a business wants to act as a "stalking horse" who spends time and money negotiating a floor price that enables a seller to secure a higher offer from another bidder. As a result, purchasers press for exclusivity arrangements in their purchase agreements and require sellers to use some degree of efforts, post-signing, to obtain required consents so the parties can proceed to an expeditious closing.

The recent decision of the Delaware Court of Chancery in *WaveDivision v. Millennium*[1] illustrates that Delaware courts will not countenance the breach of such provisions by a seller who attempts to treat a binding sales contract "as something [it] could retain as an option." In so ruling, the Court rejected seller's argument that fiduciary duties purportedly owed to creditors somehow negate these freely-negotiated contractual provisions and instead awarded damages calculated on the basis of the jilted purchaser's "reasonable expectations at the time of breach."

Background

Millennium Digital Media Systems, L.L.C., which was formed in 1998 "to acquire, develop, and operate cable systems," is controlled by three investment entities, each of whom are represented on Millennium's Management Committee, "which was effectively

[1] C.A. No. 2993-VCS (Del. Ch. September. 17, 2010).

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the governing organ for all of Millennium's entities." One of these entities designated two managers of one of Millennium's creditors, who also served as that entity's advisor, as its representatives on the Management Committee. Another employee of one of the creditors served as "a de facto manager of Millennium, and wielded great influence over other Millennium managers."

After a series of unsuccessful refinancings, in 2005 Millennium's creditors demanded that the company sell assets in order to repay debt. To that end, on December 19, 2005, Millennium entered into a letter of intent with WaveDivision Holdings LLC, a competing cable operator, for the proposed sale of two of Millennium's cable systems. This letter of intent contained an "exclusivity" provision whereby Millennium agreed, for a period of 30 days, not to pursue other direct or indirect sale options with regards to the systems. Despite this undertaking, Millennium began almost immediately to "actively – and secretly – " discuss with certain of its creditors an alternative transaction to refinance existing indebtedness by offering the assets promised to Wave as security. Members of Millennium management pursued the refinancing option, including preparing projections and discussing them with Millennium's creditors, while simultaneously working on definitive purchase agreements with Wave.

On February 8, 2006, Millennium and Wave entered into purchase agreements for the sale of the two systems. Under these agreements, Millennium agreed, among other things, to use "commercially reasonable efforts" to obtain any consents required to complete the sale, including consents from creditors. The agreements also contained a "No Solicitation" provision, which required Millennium to deal exclusively with Wave and to refrain from engaging in any solicitation for, or encouraging, any alternative transaction involving the systems being sold to Wave. However, Millennium retained the right to terminate the agreements "if closing had not occurred by June 30 so long as Millennium had not proximately caused the closing's non-occurrence."

Even so, the next day, Millennium management informed creditors that it was "actively pursuing various alternatives, including refinancing options." In fact, Millennium's General Counsel went so far as to notify the creditors that by virtue of the purchase agreements, they "would be given a 'two month option on the Transaction … .'" Consistent with this approach, Millennium retained a firm "to act as a financial and operational advisor in connection with a review of potential investments in the capital structure of [Millennium]." This firm, working alongside Millennium management, prepared various assessments and models of Millennium that were delivered to the company and certain creditors. Exactly one month after the purchase agreements with Wave were signed, Highland Capital Management, one of Millennium's creditors, offered to undertake the refinancing.

Millennium continued to "pursue parallel tracks," negotiating definitive terms for the refinancing with Highland while keeping Wave on the hook under the purchase agreements. Even though several of the creditors had notified Millennium that they would not consent to the sales to Wave and instead championed the refinancing transaction, Millennium decided not to advise Wave of these developments, despite direct inquiries from Wave asking "on what basis [the creditors] would agree to sign the consents." Then, on July 28th, Millennium notified Wave that it was terminating the purchase agreements because the June 30th deadline had passed without a closing due to the failure to obtain consents from the creditors. Later that same day Millennium closed the refinancing deal with Highland, effectively transferring control of the company to its former creditors.

After being jilted by Millennium, Wave purchased two other cable systems and, some months later, filed suit against Millennium. In this lawsuit Wave sought damages for, among other things, Millennium's alleged breach of the commercially reasonable efforts and no solicitation clauses of the purchase agreements. After a full trial on the merits, the Court ruled in favor of Wave and awarded "its expectancy damages" calculated with a view to "the profits it expected to make, if it can prove them up with reasonable certainty."

The Court's Analysis

Because the purchase agreements were by their terms governed by Delaware law, the Court analyzed Wave's claims by applying Delaware contract law principles.

Breach of the "No Solicitation" Clause

The Court concluded that "Millennium's actions in pursuing the 'parallel paths' of exploring a refinancing while at the same time pursuing the sale of the Systems to Wave violated the no solicitation provision of the Agreements." In the Court's view, "Millennium repeatedly and persistently breached this provision" by developing the refinancing option with the creditors, utilizing "its own managerial expertise and company confidential information" and "retaining an independent consultant whose retention explicitly included exploring the viability of the very transactions expressly covered by the no solicitation clause." On this basis, the Court found that Millennium "'assisted,' 'facilitated,' and 'encouraged' an alternative transaction" in clear breach of the no solicitation clause.

In so ruling, the Court rejected each of Millennium's arguments as to why it should be excused from honoring its undertakings under the purchase agreements with Wave. First, the Court was, "to put it an understated way, not convinced" by Millennium's "attempts to frame its unusual and duplicitous conduct in the months after signing the Agreements as an elaborate attempt to obtain the consent of its lenders." Second, the Court dismissed Millennium's "no harm, no foul" argument that the creditors would not have approved the sales to Wave even in the absence of the refinancing alternative, declaring that "Millennium cannot rely on the failure of a condition … when its own conduct materially caused the condition's failure." Finally, the Court pushed aside Millennium's attempt "to create a false conflict between the reasonable best efforts clause and the no solicitation clause," stressing not only that "there is nothing inconsistent about the two provisions," but that "the no solicitation clause is clearly designed to make obtaining consent more likely."

Millennium also attempted to convince the Court that adherence to the no solicitation clause "would have forced the Management Committee to breach its fiduciary duties to its creditors" and, therefore, "cannot be enforced against it as a matter of law." The Court would have none of this, concluding that "[t]his argument makes no economic or legal sense." While acknowledging "some admittedly odd authority on the subject," the Court instructed that "Delaware entities are free to enter into binding contracts without a fiduciary out so long as there was no breach of fiduciary duty involved when entering into the contract in the first place. To generate wealth for investors, fiduciaries must be able to bind the entity to contracts." Given the creditors' early encouragement of the sales process and their representation on Millennium's Management Committee, the Court characterized the argument that such a governing body could not enter into a "sales contract with the high bidder containing a no solicitation clause" as "frivolous."

Breach of the "Commercially Reasonable Efforts" Clause

The Court also determined that Millennium breached the commercially reasonable efforts provision of the purchase agreements with Wave. "The clearest evidence," the Court noted, "that Millennium did not comply with its duty to use its reasonable best efforts to obtain consent was that it spent most of its energy and resources helping to develop an alternative to the sale, efforts designed to thwart, not obtain" the necessary consents of its creditors. To make matters worse, in the Court's view, "Millennium kept Wave in the dark and on a string so it could prospect for a better deal … . This clandestine approach employed by Millennium … guts its claim to have been actively pursuing consents in good faith."

Conclusion

In light of *Revlon*[2] and its progeny, M&A practitioners have become accustomed to including "fiduciary out" provisions (usually subject to match rights and payment of a termination fee) in public company merger agreements which implicate a sale of control of the target company. Such provisions are necessary because of the inherent delay between the signing of the merger agreement and the shareholder vote on the transaction. In private M&A transactions, on the other hand, a "fiduciary out" is rarely included because shareholders can approve the transaction up front. As the decision in *WaveDivision v. Millennium* demonstrates, a seller that does not successfully bargain for such an escape clause may find itself liable in damages for breaching contractual exclusivity or commercially reasonable efforts provisions, even when it attempts to invoke compliance with fiduciary duties as a pretext for such breach. It is indeed comforting that Delaware courts continue to honor such freely-negotiated provisions.

[2] *Revlon v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173 (Del. 1986). For a discussion of a recent Court of Chancery decision applying *Revlon* principles, please *see* our Client Alert entitled "Delaware Court Refuses to Enjoin Dollar Thrifty Merger With Hertz," October 12, 2010.

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