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November 15, 2010

Corporate Governance Group Client Alert

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DELAWARE COURT REFUSES TO ENJOIN 3M TENDER OFFER FOR COGENT

Rejects claims that directors failed to satisfy Revlon duties and agreed to deal protections that precluded potential higher bid

In September, the Delaware Court of Chancery refused to stand in the way of a proposed merger between car rental companies Dollar Thrifty and Hertz,[1] providing valuable insight into how the Court will analyze a claim that directors failed to satisfy their *Revlon* duties.[2] Similarly, a recent ruling by the Court of Chancery in *In re Cogent, Inc. Shareholder Litigation*[3] makes clear that while a board of directors in "*Revlon* mode" is required to "pursue the best transaction reasonable available … there is no single path that a board must follow to reach the required destination of a maximizing stockholder value. Rather, directors must follow a path of reasonableness which leads toward that end."

The *Cogent* decision illustrates that if directors can establish that "they were adequately informed and acted reasonably," the Court will not second guess their consideration of factors – such as deal certainty – in addition to price, or their agreement to reasonable deal protection measures. The decision also reminds us, however, that this is essentially a facts-based analysis in which the Court will focus specifically on the context in which a sales process is carried out and the perceived impact of deal protection measures on competing bidders.

[1] *In re Dollar Thrifty Shareholder Litigation*, 2010 WL 3503471 (Del. Ch. Sept. 8, 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.

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

[3] *In re Cogent, Inc. Shareholder Litigation*, Cons. C.A. No. 5780-VCP (Del. Ch. Oct. 5, 2010).

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Background

Cogent, Inc. is a leading supplier of automated fingerprint identification systems to governments, law enforcement agencies and organizations worldwide. In 2008, Cogent's board of directors, with the assistance of its financial advisors Credit Suisse and Goldman Sachs, began exploring possible "strategic opportunities." Due to the volatility in the financial markets following the economic downturn, however, Cogent "found it difficult to attract firm offers." Of the 27 potential bidders contacted, only five entered into nondisclosure agreements with Cogent. Subsequently, Cogent received expressions of interest and entered into discussions with four parties: 3M Company and three other companies denominated by the Court as Companies B, C, and D.

Both Companies B and C dropped out of the process by the summer of 2010, but discussions with 3M and Company D became more serious. On July 2nd, 3M submitted a written nonbinding proposal offering to acquire Cogent for $10.50 per share with no financing contingency. This offer was contingent, however, on "retention arrangements with key employees including Mr. Hsieh," Cogent's founder and CEO. The Cogent board met on July 6th to consider 3M's proposal, but determined that the $10.50 per share price "must be improved" and rejected 3M's request for exclusive negotiations.

On August 17th, Company D submitted a preliminary nonbinding indication of interest with a price range of $11.00 to $12.00 per share. Company D's offer did not contain a financing condition, but was subject to various conditions "including the completion of satisfactory due diligence." Cogent sought to accelerate the process with Company D by suggesting a face-to-face meeting, but Company D failed to respond to this overture.

After learning of Company D's higher bid, 3M sent a letter to Cogent's board on August 19th stating that it would formally withdraw its earlier $10.50 per share offer if a deal was not reached by the close of business on August 20th. Cogent's board reviewed both offers and determined that risks associated with Company D's bid – the due diligence condition, antitrust and regulatory issues and Company D's apparent reluctance to engage with Cogent – made 3M's offer more attractive. In view of 3M's threat to withdraw its offer, the Cogent board decided to negotiate a merger agreement with 3M while continuing to supply Company D with information.

On August 30th, Cogent announced its agreement to be acquired by 3M at $10.50 per share in cash. No further progress had been made with Company D. The acquisition was structured as a two-step transaction, with 3M first making a tender offer for Cogent shares which, if successful, would be followed by a merger in which all untendered shares would be converted into cash at the tender offer price. To facilitate the second step, 3M negotiated a top-up option allowing it to purchase up to 139 million additional shares. If sufficient shares were acquired in the tender offer, exercise of the top-up option would enable 3M to reach the 90% level and effect a statutory short-form merger. If it chose to exercise the top-up option, 3M was permitted to pay the purchase price, in its discretion, by delivery of cash or a promissory note due in one year.

The merger agreement also contained several deal protection measures, including a "no-shop provision with a fiduciary out clause," a five-day right on the part of 3M to match any subsequently-received superior proposal and a termination fee of $28.3 million. At the same time, 3M entered into two agreements with Hsieh: one that would pay him a retention bonus of $153,000 if the transaction were to close, and another effectively locking up his 38.88% stake in Cogent's shares in support of the transaction unless the board exercised its fiduciary out.

On September 1st, two Cogent stockholders filed a complaint with the Court of Chancery claiming, among other things, that the Cogent directors breached their fiduciary duties of loyalty, candor and good faith by agreeing with 3M to (i) a purchase price that "was too low as a result of an inadequate and unfair sales process" and (ii) "preclusive deal protection devices and related agreements that made it extremely unlikely that another party would submit a Superior Proposal." Then, on September 3rd, plaintiffs moved for a preliminary injunction.

The Court's Analysis

In denying plaintiffs' motion for a preliminary injunction, the Court concluded that plaintiffs did not have "a reasonable possibility of success on the merits." Before addressing plaintiffs' specific allegations, the Court explained that a court reviewing a board's actions in the *Revlon* context is required to "(1) make a determination as to whether the information relied upon in the decision-making process was adequate and (2) examine the reasonableness of the directors' decision viewed from the point in time during which the directors acted." The Court then turned to an analysis of the various aspects of the 3M transaction challenged by plaintiffs.

Revlon Challenge – Process and Price

Process. With respect to the process followed by the Cogent board, the Court focused on four factors in determining that "the Board followed a reasonable course of action":

- *First*, in response to plaintiffs' claim that the board's pre-market check was too limited, the Court noted that "the Board hired two investment banking firms specifically for the purpose of drumming up potential suitors for Cogent and facilitating discussions on its behalf" and "engaged in communications with numerous potential strategic partners."

- *Second*, rejecting plaintiffs' claim that the board improperly delegated negotiations to management, the Court observed that the 3M transaction was "the culmination of a careful process" rather than a "short-circuiting of the auction process."

- *Third*, "the record does not support Plaintiffs' argument that the Board was biased in favor of 3M." Three of the four board members "were both disinterested and independent." Moreover, "Hsieh's interests appear to be closely aligned with those of the stockholders as a whole," particularly in light of the fact that "his retention bonus is less than 1% of the additional money Hsieh would stand to make if Company D were to succeed in buying Cogent even at the low end ($11.00) of its tentative offer."

- *Fourth*, plaintiffs' claim that Company D was not given adequate time to conduct diligence in order to solidify its offer was, in the Court's view, "unconvincing." To the contrary, the board "made substantial efforts to engage with Company D," even hiring Goldman "for the specific purpose of reaching out to Company D." Furthermore, Cogent's board rejected exclusive talks with 3M for almost two months, provided both bidders with equal access to its data room and "consistently attempted to get Company D to speed up its pace by alerting them to the serious level of 3M's interest." Given Company D's "lukewarm response," the Court found it "reasonable for the Board to

> conclude that the lack of a firm offer from Company D in conjunction with the risk associated with its completion of due diligence represented a risk of a magnitude serious enough to justify taking the somewhat lower, but firm offer from 3M."

Price. The Court explained that "within the context of a voluntary tender offer, inadequacy of price alone is not a proper basis for a preliminary injunction." In the Court's opinion, plaintiffs' strongest ground for attacking the fairness of the price was the potentially higher offer from Company D. However, Company D's offer was a "nonbinding expression of intent … contingent on the completion of its due diligence," whereas 3M had made a "firm offer." On this basis, the Court determined that the board acted reasonably in concluding that "the greater certainty associated with 3M's bid outweighed the risk of waiting for a potentially higher offer from Company D that might never materialize." The Court also recognized that Credit Suisse advised the board that 3M's $10.50 per share offer was above the high end of the valuation range, and that because Credit Suisse's fee "was pegged to the size of any resulting transaction, it had an incentive to seek the highest price possible to maximize its potential fee."

Deal Protections

The Court rejected plaintiffs' characterization of the deal protection measures in the merger agreement as unreasonably "preclusive." Whether judged individually or based on their "cumulative effect," the Court was not persuaded that these provisions "unreasonably inhibited another bidder from making a Superior Proposal." To the contrary, "if someone were to make a firm offer of $11.00 today, there is no reason to believe the Cogent Board would not consider it."

No Shop and Match Right. Plaintiffs argued that the no-shop provision and the five-day match right given to 3M provided potential buyers with little incentive to incur the costs necessary to try to top 3M's offer. Acknowledging that potential acquirers "often have a legitimate concern that they are being used merely to draw others into a bidding war," the Court observed that "it is reasonable for a seller to provide a buyer some level of assurance that he will be given adequate opportunity to buy the seller, even if a higher bid later emerges." As such, the impact of these provisions, which was "mitigated by the reasonable fiduciary out clause," was neither preclusive nor unreasonable.

Termination Fee. The termination fee payable to 3M upon Cogent's exercise of its "fiduciary out" represented 3% of Cogent's equity value[4] but 6.6% of Cogent's enterprise value.[5] Plaintiffs argued that enterprise value is the proper metric against which to measure the reasonableness of the termination fee because it reflected Cogent's large net cash position, which would allow any acquirer to "use the cash on the books to defray the effective cost of its bid."

In response, the Court cited the recent *Dollar Thrifty* decision for the proposition that "cash on the books of a seller should be included for the purposes of calculating the break-up fee because even the cash component 'must be matched in any topping bid.'" The Court contrasted Cogent's balance sheet with those of target companies having a significant amount of debt which contributed to their relatively higher enterprise values.

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[4] "[T]he cost necessary to purchase the equity of Cogent in the market."

[5] "[T]he equity value, plus the value of debt, minus the cash on the company's balance sheet."

The Court also observed that numerous Delaware cases have found termination fees of 3% of equity value or transaction value to be reasonable, and that "[n]othing in the record suggests that the Termination Fee here has deterred or will deter any buyer." Significantly, although the termination fee payable to 3M would require a competing bidder to pay at least 35 cents more per share, Company D's contingent offer would have topped 3M's offer by 50 cents per share.

Top-Up Option. Plaintiffs claimed that the Cogent board did not properly inform itself as to the effects of the top-up option, asserting that neither the board minutes nor the disclosures sent to Cogent shareholders reflected any board discussion of this topic. The Court observed that the latter assertion was refuted in a deposition of one of the Cogent directors, who testified that the board in fact received legal advice regarding the top-up option and that "he understood the general nature of its mechanics."

Noting that top-up options "have become commonplace in two-step tender offer deals," the Court found support for the particular top-up option granted to 3M from the fact that "3M effectively would have to acquire a majority of the minority outstanding shares" in order to meet the 90% threshold necessary to effect a short-form merger. As such, it was "highly unlikely that minority stockholders will be disenfranchised as a result of the Top-Up Option."

Lastly, plaintiffs claimed that the dilutive effect of the exercise of the top-up option would reduce the value of shares submitted for appraisal by any Cogent shareholder dissenting from the second-step merger. In this regard, plaintiffs discounted the effectiveness of a provision of the merger agreement that "the fair value of the Appraisal Shares shall be determined … without regard to the Top-Up Option, the Top-Up Option Shares or any promissory note," arguing that "a private contract cannot alter the statutory fair value or limit what the Court of Chancery can consider in an appraisal." And even if such protection could be provided by contract, plaintiffs noted, "the Merger Agreement does not designate stockholders as third-party beneficiaries" with the right to enforce this provision. Despite the absence of definitive precedent, the Court cited "indications from the Court of Chancery" in support of the proposition that "there is a strong argument in favor of the parties' ability to stipulate to certain conditions under which an appraisal will be conducted …" This, the Court concluded, was "sufficient to overcome Plaintiffs' professed concerns."

Retention Agreements. The Court rejected as "specious" plaintiffs' complaint that the retention agreements entered into with key Cogent employees were unreasonable because they "require the affected employees to remain with the Company if the tender offer is successful." Not only are such agreements "not unusual in merger and acquisitions," the Court observed, but the potential retention bonus payable to CEO Hsieh "pales in comparison to what he would stand to gain if Company D's tentative offer ever came to fruition."

Voting and Tender Agreement. Finally, plaintiffs challenged the validity of the lock-up agreement between Hsieh and 3M, claiming that such agreements are "invalid if they effectively end an auction process to the detriment of a Company's stockholders." The Court pointed out that "[a] major weakness in Plaintiffs' argument is the fact that Hsieh's interests are aligned with those of the stockholders as a whole in terms of securing the best available price for his shares." The Court also observed that "the V&T Agreement poses little threat of short-circuiting a live auction process" because the lock-up terminates if the Cogent board exercises its "fiduciary out" to accept a superior transaction.

Conclusion

Like the *Dollar Thrifty* decision that came before it, the *Cogent* ruling illustrates that Delaware courts, rather than focusing merely on price, will conduct a thorough and fact-intensive analysis when determining the reasonableness of a sales process. Particularly where the board is disinterested and diligent and demonstrates legitimate concerns with respect to deal certainty, Delaware courts are not likely to hold that a board failed to fulfill its *Revlon* duties in concluding a favorable transaction with a strategic bidder without conducting a full-fledged auction. Deal protection measures such as match rights, termination fees and top-up options, as well as lock-up and retention agreements, will not alter this equation, at least so long as they are not seen as being so preclusive that they are likely to deter competing proposals.

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