In *Hokanson v. Petty*, the Delaware Court of Chancery recently dismissed a lawsuit brought by common stockholders in connection with the exercise of a buyout option granted by the corporation’s board of directors several years earlier. The plaintiffs alleged that the directors breached their fiduciary duties by allowing the corporation to be acquired pursuant to the exercise of this buyout option without first seeking better terms for the common stockholders. According to the Court, the directors were not free to walk away from existing contractual obligations, entered into four years earlier in connection with raising badly-needed financing, simply because the terms of that deal turned out badly for common stockholders.

It is important to note that the *Hokanson* plaintiffs were not entitled to challenge the original financing transaction due to the running of the applicable statute of limitations. This permitted Vice Chancellor Strine to focus on the board’s actions in connection with the exercise, rather than the grant, of the buyout option and to render a decision on narrow grounds. If that had not been the case, the Court would have been confronted with far more controversial issues with broader implications in the M&A context.

**Background**

In October 2003, Altiva Corporation, on the brink of failure, received a capital infusion from Exactech, Inc., a public corporation, in the form of preferred stock and loans convertible into preferred stock. Exactech became Altiva’s largest stockholder, owning shares representing approximately 17% of the voting power.

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1 C.A. No. 3438-VCS (2008 WL 5169633 (Del. Ch.)).
The stockholder agreement entered into in connection with Exactech’s investment included a buyout option permitting Exactech to acquire the rest of Altiva, at any time between October 2005 and October 2008, at a 20% discount to the valuation of Altiva at the time of exercise, provided that the valuation could be no less than $25 million. The structure of the buyout transaction was left to the “sole discretion” of Exactech. Also as part of the financing, the Altiva board and the requisite stockholders voted to approve a restated certificate of incorporation.

In late 2007, Exactech exercised its buyout option and elected to structure the takeover as a merger of Altiva with Exactech. As required by the stockholder agreement, the Altiva board approved the terms of a merger agreement with Exactech, which was then approved by written consent of Altiva’s preferred stockholders who controlled a majority of the voting power of Altiva’s outstanding capital stock. The consideration payable in the merger, calculated in accordance with the formula provided in the stockholder agreement, was insufficient to cover the entire liquidation preference of the preferred stockholders. This left the common stockholders with no payment under the terms of the merger agreement in exchange for their shares.

Not surprisingly, several common stockholders sought a declaratory judgment that the merger was unfair, and claimed that the directors breached their fiduciary duties of care and loyalty by permitting Altiva to consummate the merger without seeking a higher price. To support their allegations, the plaintiffs claimed that comparable companies were, at the time of Exactech’s exercise of the buyout option, selling at multiples of twice that provided for in the formula previously agreed to by Altiva in the stockholder agreement. Vice Chancellor Strine granted the defendant directors’ motion to dismiss the lawsuit.

The Court’s Analysis

At the outset, the Court noted that plaintiffs’ claims related solely to the Altiva directors’ conduct in response to Exactech’s exercise of its buyout option in 2007. Of necessity, plaintiffs did not challenge the original 2003 financing transaction, including the grant of the buyout option, because such a challenge would have been time-barred under the applicable statute of limitations. “Instead,” the Court observed, “the plaintiffs seek to condemn the Altiva board for causing Altiva to honor its contractual obligations in 2007 by assenting to the contractually required Merger.”

Next, the Court quickly dispensed with plaintiffs’ duty of care claims, citing the exculpatory provision in Altiva’s restated certificate of incorporation adopted pursuant to section 102(b)(7) of the Delaware General Corporation Law. As noted above, the restated certificate of incorporation had been approved by Altiva’s stockholders in connection with the Exactech’s original investment in 2003.

The Court spent more time dealing with plaintiffs’ breach of loyalty claims. With respect to plaintiffs’ allegations that the defendant directors suffered from conflicts of interest and lack of independence in approving the merger agreement,² the Court observed that although the CEOs of both Altiva and Exactech were members of the five-person Altiva board and could be expected to retain management positions in the surviving company, the plaintiffs did not assert any facts indicating that the remaining three directors were similarly interested or lacked independence, “leav[ing] the disinterestedness of … a majority of the board, unchallenged.” In fact, the majority of the directors had been designated by preferred stockholders (other than Exactech) who would be cashed out in the merger, and they therefore were unlikely to retain any role in the surviving company. As such, ² The Court characterized these claims of the plaintiffs as having “little, if any relevance, to this unusual context.”
these directors did not have any interest in the transaction other than receipt of merger proceeds according to the formula provided in the stockholder agreement.

The Court also rejected the notion that Exactech, as a 17% stockholder of Altiva, was a “controlling stockholder” who “dominated and controlled” the Altiva board even though a majority of its members were “independent.” According to the Court, “[o]nly where a plaintiff demonstrates actual exercise of control over corporate conduct will a holder of less than 50% of a corporation’s stock be deemed a controller. The plaintiffs provide no authority for why, absent actual exercise of control, an otherwise minority holder should be considered a controller simply because it is the largest holder.”

The heart of the Court’s opinion addressed the plaintiffs’ claims ( premised on the notion that the Altiva directors were subject to, and failed to satisfy, Revlon duties3 ) that the Altiva directors were required to seek a higher price in the merger, notwithstanding the company’s contractual obligations under the buyout option, because the purchase price formula resulted in zero consideration for the common stockholders. The Court flatly rejected the notion that Altiva’s board had any freedom to negotiate the purchase price with Exactech or walk away if it did not like the terms required under the buyout option. To drive this point home, the Court noted that “[t]he plaintiffs have cited no authority suggesting that the Altiva directors were mandated to cause the company to breach a contract and avoid the Merger. On this basis alone, the motion to dismiss must be granted.”

The Court also emphasized — more than once — that plaintiffs’ claims were ultimately meaningless, as “there is no indication that if the directors had refused to allow Exactech to exercise the buyout option unless it paid a higher price, the plaintiffs would have been better off.” Plaintiffs failed, in the Court’s view, to indicate any realistic scenario under which they would have received any consideration in the merger; even if Altiva had been valued at $50 million, instead of $25 million, the merger proceeds would still have been insufficient to satisfy the preferred stockholders’ liquidation preference, leaving nothing for the common stockholders.

**Implications for M&A Practitioners**

Although the Court explicitly distinguished Hokanson from a “garden variety merger case,” there are important parallels to more traditional M&A transactions. Because the statute of limitations had run on the Altiva board’s 2003 decision to enter into the buyout option, the parties found themselves in the same position, at the time of Exactech’s exercise of its buyout option, as if they had either (i) entered into a completely “locked-up” merger agreement or (ii) obtained stockholder approval of a merger agreement and thereby cut off any “fiduciary out” that the directors may have reserved to themselves in the merger agreement, in either case after having acted in full compliance with their fiduciary obligations. But for the running of the statute of limitations, the Court might have been presented with more difficult issues relating to whether the Altiva board was subject to, and if so had satisfied, Revlon duties in connection with the 2003 financing and grant of the buyout option. Could the board agree to the buyout option without requiring some sort of “fiduciary out”

3 Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). In Revlon, the Delaware Supreme Court ruled that a board of directors contemplating a change of control transaction should “set its singular focus on seeking and attaining the highest value reasonably available to the stockholders.”
or market check at the time of exercise? Did Altiva’s dire circumstances justify the board’s decision? Did stockholder approval of the amended and restated certificate of incorporation needed to facilitate Exactech’s investment bar any challenge to the buyout option?

However, because the statute of limitations on the original grant of the buyout option had run, the linchpin issue presented in Hokanson was far narrower: whether a board’s fiduciary duties might compel the board to breach an otherwise valid contractual obligation.

Much of the Court’s opinion appears to be a categorical rejection of the very idea that a board could properly contemplate causing the corporation to breach its existing contractual obligations. The Court declared that the Altiva board did not have the “contractual flexibility to secure a higher price than was paid in the Merger” (emphasis added), and cautioned that “[p]arties cannot repudiate their contracts simply because they wish they had gotten better terms.” The Court also noted Exactech’s expectation that Altiva would perform its obligations under the stockholder agreement in justifying this result; the bad outcome for Altiva’s common stockholders was “not a license to deny Exactech the benefits of its bargain.”

Moreover, the facts in Hokanson present us with an opportunity to read the holding even more narrowly. As Vice Chancellor Strine pointed out more than once, the plaintiffs had failed in their pleadings and oral arguments to present any plausible scenario under which they, as common stockholders, would have received any payment in the merger from either a re-negotiation with Exactech or a search for an alternative transaction. So, whether or not there may ever be circumstances under which a board’s fiduciary duty would compel it to breach an existing contractual obligation, that would certainly not have been the case under the facts of Hokanson, where doing so would, in the Court’s words, merely “put the common stockholders in the same position they would be in if the Altiva directors complied with their contractual obligations.” There appeared to be no upside for Altiva to engineer such a breach. Clearly, only Vice Chancellor Strine can explain whether he intended this discussion of the practicalities as a narrowing of his ruling that the Altiva board was not required to breach its contract with Exactech, or as a means of bolstering his decision to dismiss plaintiffs’ complaint.

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4 Vice Chancellor Strine’s opinion in Ace Limited v. Capital Re Corporation, 747 A.2d 95 (Del. Ch. 1999), would seem to suggest that he would have expected more from Altiva’s board if he had been asked to rule on the propriety of the grant of the buyout option. In Ace, the Vice Chancellor was prepared to invalidate a “no talk” provision of a merger agreement, even in a “non-Revlon” situation, noting that “[i]n this context where the board is making a critical decision affecting stockholder ownership and voting rights, it is especially important that the board negotiate with care and retain sufficient flexibility to ensure that the stockholders are not unfairly coerced into accepting a less than optimal exchange for their shares.” However, the difficult circumstances faced by Altiva when it granted the buyout option might have led to a different result. See note 5 below.

5 While implying that any traditional Revlon analysis would have been appropriate, if at all, only in 2003 (”[t]he change of control occurred in 2003,” the Court wrote), the Court indicated that it was not inclined toward sympathy for fiduciary duty claims arising out of the board’s actions in 2003 for precisely this reason. Altiva was “facing financial ruin” and the buyout option, the Court said, was simply “the cost of capital” for the struggling company.

6 For a discussion of a recent Court of Chancery decision sustaining a same-day shareholder vote following the signing of a merger agreement, see our Client Alert entitled “Omnicare of ‘Questionable Continued Vitality’?: Delaware Chancery Court rejects Application of Controversial Case in Context of Same-Day Stockholder Vote to Approve Merger”, dated September 15, 2008.

7 The emphasis on the word “compel” is significant. Boards can always elect to breach a contract if they perceive that the benefits to the corporation of doing so would outweigh the damages the corporation would have to pay to the aggrieved counterparty. This concept is known as “efficient breach”. But the fact that breaching may be in the corporation’s interest does not absolve a corporation for liability to the aggrieved party. See Smith v. Van Gorkum, 488 A.2d 858, 888 (Del. 1985).
Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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