



May 9, 2011

In Olson v. ev3, the Delaware Chancery Court Revisits Top-Up Options and Critiques the Appraisal Dilution Theory

Introduction

In *Joanne Olson v. ev3, Inc.* C.A. No. 5583-VCL (Del. Ch. Feb 21, 2011), the Delaware Court of Chancery revisited the issue of top-up options and more particularly, considered the merits of the "appraisal dilution" theory, a claim often asserted by plaintiffs in stockholder suits opposing two-step cash tender offers. Although Vice Chancellor Laster found that the parties' settlement of the "appraisal dilution" argument provided a benefit that was "ephemeral at best," he stopped short of dismissing the theory outright.

Background

On June 1, 2010, Covidien Group S.a.r.l. entered into an agreement to acquire ev3, Inc. in a two-step acquisition. In the first step, Covidien would make a cash tender offer to purchase all of ev3's outstanding shares. If Covidien acquired 90% or more of ev3's outstanding shares, it could avoid preparing a proxy statement and holding a stockholders' meeting (ordinarily needed to complete a two-step merger) and instead use a short-form merger to complete the transaction, pursuant to Section 253 of the Delaware General Corporation Law ("DGCL"). If less than 90% of the shares were acquired, a top-up option would allow Covidien to purchase from ev3 the amount of stock needed to reach the 90% threshold and then use a short-form merger, provided no other conditions needed to be met.

On June 18, 2010, Plaintiff Joanne Olson filed an action seeking to enjoin the transaction on multiple grounds, including: (i) the top-up option violated DGCL Sections 152, 153 and 157 and (ii) the top-up option would coerce stockholders to tender their shares because of the threat of "appraisal dilution." The parties then made comprehensive amendments to the merger agreement, thereby settling the substantive aspects of the dispute. The merger was completed with Covidien acquiring 87.68% of ev3's stock in the tender offer and more than 26 million top-up shares. However, to determine the compensation due to Olson, the court's inquiry involved considering the benefits that arose through the settlement of the statutory invalidity and "appraisal dilution" arguments.

Statutory Invalidity Claim

The court agreed with the plaintiff's contention that the top-up option violated DGCL Sections 152, 153 and 157. Under DGCL Section 157, the option terms and related consideration must be set forth (i) in the certificate of incorporation or in a duly adopted board resolution, and (ii) in the underlying instrument. In addition, DGCL Sections 153 and 157(d) forbid any consideration received for par value stock from having a value "less than the par value" of such stock. Finally, the board of directors must determine the sufficiency of the consideration received for the issuance of stock pursuant to DGCL Section 152.

The court held that Sections 157 and 153 were violated because the original merger agreement did not specify the consideration or a formula to determine the consideration. Although the merger agreement stated that the top-up options would be granted in exchange for a promissory note, the terms of this promissory note were to be set in the future. As a result, there was no guarantee that the consideration for the top-up shares would exceed their par value. Moreover, in contravention of Section 157(b), the option terms were not described in the certificate of incorporation or a board resolution. Finally, since the board left the consideration's "sufficiency" determination to a future date (when the terms of the promissory note would be set), Section 152 was breached. In summary, the litigation and resulting settlement prevented "the seeds of a future legal crisis from germinating." As such, the court awarded \$1 million as compensation for curing these statutory flaws.

Appraisal Dilution Theory

On the other hand, with regards to the "appraisal dilution" theory, the court found the plaintiff's argument to be of questionable merit. Here, the plaintiff argued that the top-up option would enable the issuance of up to 175 million top-up shares, nearly 1.5 times the amount of ev3's outstanding stock prior to the tender offer. In return for such shares, ev3 would have received an unsecured promissory note with unknown terms. As a result, the promissory note would be discounted in an appraisal proceeding, which would reduce the fair value of ev3 and dilute the proportionate share that a dissenting stockholder would receive through the appraisal process. In short, by making appraisal less attractive, the top-up option would coerce dissenting stockholders to tender their shares.

After acknowledging that Delaware courts had yet to take a clear stance on whether top-up options threatened "appraisal dilution," the court noted the following:

- The appraisal statute, DGCL Section 262(h), calls for the exclusion of top-up shares.
 - DGCL Section 262(h) provides that "[t]hrough [an appraisal] proceeding the Court shall determine the fair value of the shares *exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation...*"
 - In a 2004 Chancery Court decision, debt incurred to finance a cash-out merger was excluded as an "element of value" arising out of the accomplishment or expectation of a merger.¹ Thus, the court reasoned that the statutory exclusion should also apply to top-up shares issued to facilitate a merger and the consideration received in connection therewith.
- Top-up shares priced at the deal consideration are more likely to result in appraisal accretion than appraisal dilution.
 - The "appraisal dilution" argument rests on the assumption that the judicial finding of fair price would exceed the deal price.
 - However, if the deal price surpassed fair value, then the issuance of top-up shares at the deal price would increase the value of the corporation and presumably, the appraisal value.
 - In practice, an arm's length synergistic transaction allows target fiduciaries to bargain for a premium to fair value based on anticipated synergies and reduced agency costs that the acquirer obtains through sole ownership.
 - The ability of target fiduciaries to negotiate a premium to market value suggests that the merger consideration exceeds the fair value of the target as a going concern.

¹ *Cede & Co. v. JRC Acq. Corp.*, 2004 WL 286963, at *7 & n.71 (Del. Ch. Feb. 10, 2004).

- Therefore, if the consideration for top-up shares is set at the deal price, then the exercise of a top-up option will likely result in "appraisal accretion" instead of "appraisal dilution."
- The procedure for effecting appraisal rights protects against any coercion that may be caused by concerns of "appraisal dilution."
 - DGCL Section 262 provides that a demand must be made by a stockholder *before* the vote on a long-form merger or within 20 days *after* the date of mailing notice of completion of a short-form merger.
 - In addition, within 60 days after the effective date of the merger or consolidation, a stockholder has the right to withdraw the demand for appraisal and instead accept the merger consideration.
 - Due to the timing of the appraisal demand and the ability to withdraw it within 60 days after the effective date, dissenting stockholders who seek appraisal "have every incentive not to tender."
 - If the tender offer closes without obtaining sufficient shares to do a short-form merger, then stockholders can demand appraisal in advance of the long-form merger and avoid any possibility of dilution from top-up shares.
 - Even if the acquirer closes the transaction using a short-form merger, dissenting stockholders can still accept the original merger consideration and be in the exact same position as stockholders who tendered their shares.
 - Therefore, by waiting, the stockholder "who opposes the deal loses nothing, preserves flexibility, and may help defeat the transaction."

In summary, the court found the "appraisal dilution" theory collapses on the language of the appraisal statute and the practical operation of the appraisal process. However, the court did not fully reject the "appraisal dilution" argument and acknowledged that a "minimal benefit" was conferred by the plaintiff's suit, leading to, as part of the settlement, the inclusion of language mandating that top-up shares and related consideration should not be considered in appraisal proceedings. The court also noted that the inclusion of such language had been upheld in other cases before the Delaware Court of Chancery. As such, prudent transactional lawyers should continue to provide in the transaction agreement that the fair value of any appraisal shares will be calculated in accordance with DGCL Section 262, without taking into account the effect of any top-up option, top-up shares or any related consideration.

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If you would like additional information or have any questions, please contact:**

Corporate

New York

Carlos T. Albarracín
+1 (212) 408-1081
calbarracin@chadbourne.com

Marc A. Alpert
+1 (212) 408-5491
malpert@chadbourne.com

A. Robert Colby
+1 (212) 408-5571
rcolby@chadbourne.com

William Greason
+1 (212) 408-5527
wgreason@chadbourne.com

Morton E. Grosz
+1 (212) 408-5592
mgrosz@chadbourne.com

Charles E. Hord, III
+1 (212) 408-5353
chord@chadbourne.com

Sey-Hyo Lee
+1 (212) 408-5122
shlee@chadbourne.com

Jonathan M.A. Melmed
+1 (212) 408-1002
jmelmed@chadbourne.com

J. Allen Miller
+1 (212) 408-5454
amiller@chadbourne.com

Richard Ross
+1 (212) 408-5386
rross@chadbourne.com

Edward P. Smith
+1 (212) 408-5371
esmith@chadbourne.com

Kevin C. Smith
+1 (212) 408-1092
ksmith@chadbourne.com

Ayşe Yüksel
+1 (212) 408-1047
ayuksel@chadbourne.com

Dubai
Ayşe Yüksel
+971 (4) 331-6123
ayuksel@chadbourne.com

London
Charez X. Golvala
+44 (0) 20-7337-8020
cgolvala@chadbourne.com

Claude S. Serfilippi
+44 (20) 7337-8030
cserfilippi@chadbourne.com

Washington
Sean P. McGuinness
+1 (202) 974-5680
smcguinness@chadbourne.com

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