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The Validity of Stockholders' Representatives after *Aveta*

David Schulman, Tony Chan, and Jordan McKay of Dechert LLP

Although it is common practice to appoint a stockholders' representative to facilitate post-closing matters under merger agreements governed by Delaware law, there had been little definitive guidance and accordingly, some uncertainty amongst practitioners, as to whether and to what extent these arrangements were enforceable and binding upon all stockholders. On September 20, 2010, the Delaware Court of Chancery, in *Aveta Inc. v. Cavallieri*, C.A. No. 5074-VCL (Del.Ch.), addressed this uncertainty in holding that a contractual mechanism for determining the amount of merger consideration, including the appointment of a stockholders' representative under the merger agreement to resolve issues relating to merger consideration with respect to post-closing purchase price adjustments, was authorized under the Delaware General Corporation Law as a fact ascertainable outside of the agreement as well as binding upon the minority stockholders, regardless of agency law.

Notwithstanding the broad holding in *Aveta*, there are limits to the authority delegatable to a stockholders' representative and M&A practitioners should be careful not to exceed those limitations. Additionally, even when within the ambit of the authority contemplated under *Aveta*, practitioners should ensure that the provisions providing for the grant of authority to the stockholders' representative comply with requirements of the DGCL as interpreted by *Aveta* and other cases.

Background

In 2006, Aveta Inc., a Delaware corporation ("Aveta"), acquired Preferred Medicare Choice Inc., a Puerto Rico corporation ("PMC"), which operated a provider network of doctors and other health professionals in Puerto Rico. Prior to the acquisition, PMC had two classes of shares outstanding: Class A shares, which comprised 51% of PMC's issued and outstanding stock and were owned by a group of four individuals (the "Class A Stockholders"), and Class B shares, which comprised the remaining 49% of PMC's outstanding shares and were owned by over 100 individuals (the "Class B Stockholders").

The transaction was voted on and approved solely by the Class A Stockholders, each of whom were also signatories to the Agreement and Plan of Merger and Stock Purchase (the "Merger Agreement"), while none of the Class B Shareholders signed the Merger Agreement or were entitled to vote on the transaction. Pursuant to the Merger Agreement, the transaction transpired over several steps: Aveta first purchased all of the Class A shares from the Class A Stockholders for 60.93% of the total merger consideration, which included a $157 million cash payment at closing, and then a newly-formed Puerto Rico acquisition subsidiary of Aveta merged into PMC, with PMC surviving. As a result of the merger, the Class B Stockholders were entitled to receive the remaining 39.07% of the total merger consideration.

The Merger Agreement contemplated potential earn-out payments during a two year period after closing as well as post-closing adjustments to the merger consideration to reflect working capital and claims experience for liabilities incurred but not recorded at closing; the Merger Agreement also provided for the appointment of a stockholders' representative, Robert Bengoa, to resolve issues relating to the various post-closing purchase price adjustments and specified mechanisms for calculating these amounts and resolving any disputes relating thereto. After the transaction closed, and after nearly a year of unsuccessful negotiations between Aveta and Bengoa regarding the post-closing adjustments, Aveta and Bengoa executed an agreement appointing Ernst & Young LLP as the sole arbitrator, whose decision would be

final and binding, all in compliance with the provisions set forth in the Merger Agreement regarding disputes between the parties, after which Aveta attempted to arbitrate with Bengoa, while Bengoa refused to proceed with the arbitration.

During this period, former Class A and B PMC stockholders attempted to revoke Bengoa's designation as stockholders' representative, claiming that he lacked the authority to represent them. In response, Aveta filed suit in the Delaware Court of Chancery against the former PMC seeking to resolve the question as to "whether the contractual process for calculating the consideration, including the outcome of the [Ernst & Young] arbitration, binds all former PMC stockholders."

Aveta

Class A Stockholders. Addressing the ability of the former stockholders to revoke Bengoa's authority, the court first held as a matter of agency law that the Class A Stockholders, as signatories to the Merger Agreement, were bound by Bengoa's actions because they irrevocably appointed Bengoa as their agent under the Merger Agreement.

Choice of Law. Although the merger agreement provided that it would be governed by Delaware law, under the internal affairs doctrine, the court determined that the law of Puerto Rico governed the internal corporate mechanics of the merger—including the conversion of Class B shares—since the two corporations party to the merger were incorporated in Puerto Rico. Accordingly, the court applied Section 3051 of the General Corporation Law of 1995 of the Commonwealth of Puerto Rico (the "PRGCL"), which paralleled Section 251 of the DGCL as it existed in 1995. Both Sections provided that "Any 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*."

Class B Stockholders. After an analysis of the legislative history of both statutes and relevant case law, the court determined that the Class B Stockholders were bound under the relevant provisions of corporate law since the post-closing adjustments easily qualified as provisions dependent on "facts ascertainable outside of the merger agreement." In making this determination, the Court noted that "facts" included "determinations and actions of a designated person or body", including Bengoa as the stockholders' representative and Ernst & Young as arbiter. In reaching its holding, the Court noted that while post-closing adjustment turned on financial figures derived from financial statements, the formulas for deriving those amounts were "clearly and expressly" set forth in the Merger Agreement. Accordingly, although Class B Stockholders were not signatories to the merger agreement and had not entered into an agency relationship with Bengoa, the court held that Puerto Rico, and Delaware, corporate law dictated that they were still bound by the terms of the merger agreement, including the post-closing adjustment provisions.

After *Aveta* and the Limits of Delegatable Authority

In a number of cases leading up to *Aveta*, the Delaware Court of Chancery recognized that a merger agreement could authorize a stockholders' representative to act on behalf of the stockholders in certain circumstances. For example, in *Ballenger v. Applied Digital Solutions, Inc.*, the court noted that the merger agreement could confer authority with respect to certain matters on stockholders' representatives in reaching its holding where three stockholders' representatives sued to enforce an acquirer's contractual obligation to make post-closing earn-out payments. 2002 WL 749162, at *10 (Del. Ch. Apr. 24, 2002).

Subsequently, in *Coughlin v. NXP B.V.*, the court determined that a stockholders' representative had standing to pursue an action for breach of contingent payment rights under a merger agreement on behalf of the stockholders, without their involvement, based on provisions in the merger agreement specifically authorizing the same, but in doing so, noted that the provisions regarding the authority of the stockholders' representative to bind the stockholders did not need to be exhaustive. 2010 WL 1531596, at 2 (Del. Ch. Apr. 15, 2010).

Aveta, taken together with *Coughlin*, and *Ballenger*, provides M&A practitioners substantially more certainty as to whether provisions in a merger agreement appointing a stockholders' representative and providing for the determination of post-closing adjustments based on facts ascertainable outside of the agreement will be binding on minority shareholders who neither sign the agreement nor vote on the transaction.

While *Aveta* held that a stockholders' representative may be validly appointed pursuant to a merger agreement to act on behalf of all stockholders, including those not party to the merger agreement, there are limits regarding the scope of authority that may be delegated to stockholders' representatives and M&A practitioners need to take care to not exceed these limits when drafting such provisions. In *Aveta*, the court noted that the merger considerations delegated to a stockholders' representative should not be "impermissibly vague" or "constitute an improper abdication, or otherwise give rise to a breach of fiduciary duty," instead looking favorably upon the fact that the merger agreement established a clear formula and procedure "[that] must be followed." The *Aveta* Court cites additional examples where the delegation exceeded the limits allowed under Delaware law, including *Nagy v. Bistricer*, 770 A.2d 43 (Del. Ch. 2009), which held that the merger agreement could not broadly cede the determination of the merger price to the acquirer of the company, and *Jackson v. Turnbull*, 1994 WL 174668 (Del. Ch. Feb. 8, 1994), which held that the merger agreement could delegate to an individual unfettered discretion to determine the merger consideration.

Given the breadth of the decision in *Aveta*, it is likely that subsequent cases will further refine its contours with regards to the scope of authority that may be delegated to a stockholders' representative. Until then, *Aveta*, taken together with other cases discussed herein, presents an instructive framework for practitioners. Although these requirements arguably establish a low threshold, M&A practitioners should ensure that the proposed provisions remain within the limits described in *Aveta* and its predecessors.

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Editor: **Broc Romanek**, former SEC attorney and Editor of DealLawyers.com and TheCorporateCounsel.net. Broc can be reached at broc@deallawyers.com.