VEDDER PRICE

Financial Services Report

A report designed to provide news and analysis of recent legal and regulatory developments in the financial industry

February 2003

DELAWARE SUPREME COURT: MERGER VOTE CAN NOT BE LOCKED UP

The Supreme Court of Delaware recently issued an order in a case that promises to have significance for future merger transactions involving Delaware law. While the Supreme Court has not yet revealed its legal analysis by issuing its written opinion in the case of *Omnicare, Inc. v. NCS HealthCare, Inc.*,[1] the facts of the case and the Supreme Court's conclusions set forth in its order regarding the fiduciary duties of directors as they relate to transaction protection devices, or "lock-ups," suggest that certain current practices in Delaware mergers are no longer valid. A shareholder voting agreement without a "fiduciary out" clause, coupled with a contractual duty to put the merger to a vote where the approving vote is a certainty, is now illegal. Other current practices may be.

"A shareholder voting agreement without a fiduciary out clause, coupled with a contractual duty to put the merger to a vote where the approving vote is a certainty, is now illegal."

NCS HealthCare, Inc. ("NCS"), prior to its ultimate acquisition,[2] was a Delaware corporation headquartered in Cleveland, Ohio that provided pharmaceutical and related services to long-term care facilities.[3] NCS became the subject of competing acquisition bids by two companies in the same industry: Genesis Health Ventures, Inc., a Pennsylvania corporation ("Genesis"), and Omnicare, Inc., a Delaware corporation headquartered in Covington, Kentucky ("Omnicare"). NCS first contacted Omnicare about a possible acquisition transaction, but when initial discussions with Omnicare did not progress into serious negotiations, NCS solicited Genesis for an acquisition bid.

Negotiations with Genesis resulted in the execution of a definitive merger agreement in which Genesis agreed to pay approximately $1.60 per share of NCS common stock, notwithstanding the fact that Omnicare submitted a competing offer to NCS of $3.00 per share of NCS common stock immediately prior to the merger agreement's execution.[4] Omnicare's offer contained

L. William Seidman of CNBC-TV at the Vedder Price 14th Annual Banking Conference

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several conditions, including a "due diligence out," and NCS chose to proceed with Genesis to avoid squandering its fully negotiated agreement with Genesis.[5]

The Genesis merger agreement contained three lock-up devices designed to provide reasonable, but not total, assurances of consummation of the transaction:

(i) a standard "no-shop" provision, in which the NCS board agreed not to solicit competing offers unless its fiduciary duties compelled it to do so;

(ii) a break-up fee to be paid to Genesis upon the occurrence of certain events that would impede consummation of the transaction; and

(iii) a provision that the merger would be submitted to NCS stockholders for approval regardless of whether the NCS board continued to recommend the transaction.[6]

In addition, the two largest stockholders of NCS, both NCS key executives and members of the NCS board, who controlled sixty-five percent (65%) of NCS's total vote, granted to Genesis voting agreements that provided Genesis with irrevocable proxies to vote all of the stockholders' shares in favor of the Genesis merger agreement and against any other proposal.[7] Importantly, the voting agreements did not contain any provisions permitting the stockholders to withdraw their approval of the Genesis merger if a superior offer from a third party was received. The terms of the Genesis merger agreement coupled with the voting agreements gave rise to the subject litigation initiated by Omnicare and NCS minority stockholders.

The combination of the voting agreements and the merger agreement provision that called for the submission of the merger to NCS stockholders for approval regardless of the NCS board's position on the merger *effectively guaranteed stockholder approval of the merger with Genesis*. Accordingly, if the NCS board received a higher, or even substantially higher, offer before the closing of the merger, the NCS board had no legal ability to walk away from the Genesis transaction to pursue a higher price.

In general, Delaware corporations, acting through well-informed boards who are free from conflicts of interest, can enter into merger agreements that are essentially free from attack. In some circumstances, Delaware law imposes fiduciary duties on directors in the context of a merger to seek the highest value reasonably available for the corporation's stockholders. Lock-up terms in these cases face special scrutiny. In almost all cases, directors in Delaware must avoid actions that preclude voluntary stockholder action or that coerce involuntary stockholder action. These legal principles have not, however, been applied to shareholder voting agreements where directors are wearing different hats – as stockholders. Directors were typically free to vote their shares regardless of how their duties as director might instruct them. In its order, the Supreme Court invalidated the Genesis merger agreement because the lock-up devices approved by the NCS board guaranteed stockholder approval of the merger while completely precluding the board's ability to continue to satisfy its fiduciary obligation to seek the highest value reasonably available for NCS stockholders.[8] By surrendering its ability to walk away from the Genesis transaction, the NCS board was unable to accept an offer from Omnicare that would have yielded a price more than double that offered by NCS.[9]

> ***"In general, Delaware corporations, acting through well-informed boards who are free from conflicts of interest, can enter into merger agreements that are essentially free from attack."***

Lock-up devices are very common features of merger agreements because they provide acquiring corporations comfort that the substantial time, cost and effort expended in negotiating a merger agreement will not be wasted if target corporations have the unfettered ability to walk away from a signed merger agreement to pursue higher offers. Although the Supreme Court has not yet revealed its analysis in the *Omnicare* case and it is thus too early to discern precisely which fiduciary

duties were breached by the NCS board, it is not too early to learn another important lesson about a Delaware board's fiduciary duties as they relate to lock-up devices.

Practical Effect

Lock-up devices will continue to be enforceable to the extent that they do not require a board of directors to turn a blind eye to superior competing offers. The NCS/Genesis merger would have likely survived judicial challenge if the NCS board had negotiated a merger agreement that permitted the merger recommendation to be withdrawn upon a higher offer emerging, coupled with the stockholder voting agreements containing a "fiduciary out" clause permitting the two NCS stockholders to vote for alternative transactions. Instead, the directors agreed to put the merger to a vote, despite their withdrawn recommendation, had no practical impact. The mandated stockholder vote linked to pre-ordained stockholder approval made the merger a *fait accompli* from day one.

[1] Del. Supr. Nos. 605, 2002 and 649, 2002 (Dec. 10, 2002).

[2] Omnicare, Inc. announced the completion of its acquisition of NCS on January 16, 2003 for a price of $5.50 per share of NCS common stock and the repayment of NCS debt, for a total transaction value of approximately $460 million (Omnicare, Inc. Press Release, Jan. 16, 2003). The Supreme Court order was issued over a 3-2 vote with the Chief Justice dissenting.

[3] NCS was in serious financial difficulty at all relevant times. Duties of directors of insolvent, and near-insolvent, corporations differ from those where the corporation is financially healthy. The forthcoming opinion of the Supreme Court may shed more light on this topic.

[4] *Omnicare, Inc. v. NCS HealthCare, Inc.*, Del. Ch., C.A. No. 19800, Lamb, VC at 4 (Oct. 25, 2002).

[5] Frederick H. Alexander, *Delaware Supreme Court Addresses Deal Protection, Enjoins Acquisition in Omnicare, Inc. v. NCS HealthCare, Inc.*, Corporate Counsel Weekly, Jan. 15, 2003 at 24.

[6] *Id.* at 22.

[7] Del. Ch., C.A. No. 19800, Lamb, VC at 5 (Oct. 25, 2002). Notably, Delaware General Corporation Law Section 251(c) requires that only a statutory majority stockholder vote is necessary to approve a merger.

[8] Del. Supr. Nos. 605, 2002 and 649, 2002 (Dec. 10, 2002).

[9] Subsequent to its offer of $3.00 per share, Omnicare submitted a tender offer for $3.50 per share of NCS common stock. Del. Ch., C.A. No. 19800, Lamb, VC at 7 (Oct. 25, 2002).

FED PLAYS HARDBALL WITH ACQUIRORS

The Federal Reserve has recently tightened its policy on bank holding company expansion where regulatory approval is required. The Fed has told several Vedder Price clients recently that approval was problematic unless the acquirors were well capitalized by all relevant ratios *prior to filing for approval*. Regulatory approval by the local reserve bank under delegated authority required these capital levels pre-filing. Otherwise, the application had to be submitted to Washington for full Board of Governors approval. This can be time-consuming and the risk of denial is ever present. In the past, the Federal Reserve has permitted expanding institutions to commit to required capital levels as part of the application process, and to achieve them by agreed-to dates (typically consummation of the transaction). The Fed's policy shift basically says, "If you're not well capitalized, don't even apply."

> ***"The Fed's policy shift basically says, 'If you're not well capitalized, don't even apply.'"***

This policy shift has caused clients to avoid the Federal Reserve approval process and use non-member state banks or national banks as the acquiror. This option is not always feasible, however.

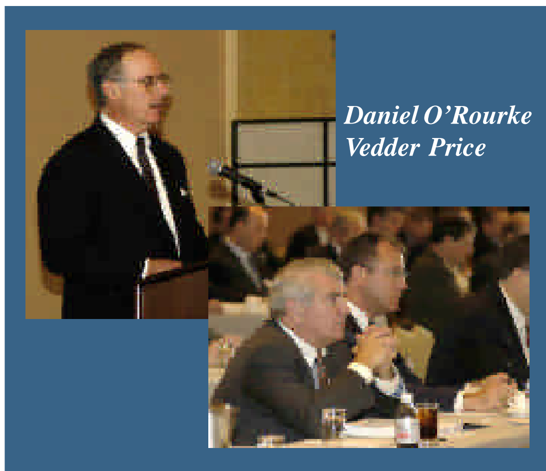
The Fed's get-tough attitude was reinforced with its December 23, 2002 denial of Illini Corp.'s proposed acquisition of Illinois Community BankCorp ("ICB"). In its denial, the Fed cited its long-standing "source of strength" doctrine and the doctrine's application to would-be acquirors who were experiencing weaknesses in their existing businesses. The Fed specifically noted the acquiror's level of capital on a consolidated basis was significantly below the level of its peer group organizations. In this case, ICB had been subject to a cease and desist order requiring its subsidiary bank to increase its tier-one leverage capital ratio to at least 7%.

Together, the two organizations would pose additional capital demands on Illini. While the acquiror informed the Fed of its plan to raise capital, the timing of the plan was unclear and uncertain. "Accordingly, the Board concludes that the financial resources and future prospects of **[buyer]** and **[seller]** and their subsidiary banks, are not consistent with approval of the proposal as currently structured."

Illini's press release following the denial was full of ire, complaining that the Fed had overridden the local reserve bank, the FDIC and the Illinois banking commissioner's office. Illini promised an appeal. Suffice it to say, the Fed is not bound by recommendations by its local reserve bank or other regulators and, from time to time, rejects their recommendations. Also, a successful appeal of a Federal Reserve Board order to the courts is rare.

L. WILLIAM SEIDMAN JOINS VEDDER PRICE FOR 14TH ANNUAL BANKING CONFERENCE

The 14th Annual Banking Issues Update was held in Chicago in October 2002. William Seidman, former Chairman of the FDIC and the Resolution Trust Corporation, joined members of the firm's Financial Institutions Group, for an in-depth review of corporate governance issues facing publicly and privately held banks and thrifts in light of recent corporate scandals and the onslaught of reform legislation. Mr. Seidman is currently Chief Commentator for CNBC-TV and is the publisher of *Bank Director* magazine. Mr. Seidman spoke at a breakfast roundtable meeting for CEOs and addressed the general session of the conference as well.



Daniel O'Rourke Vedder Price

PANEL ONE: Bank Corporate Governance Post-Enron

Daniel O'Rourke, chair of the firm's Financial Institutions Group, moderated the lead panel on corporate reform. Panelists included **Jennifer Evans**, a Securities Partner at Vedder Price; **James W. Nelson**, Senior VP, Supervision and Regulation of the Federal Reserve Bank of Chicago; **George Morvis**, CEO of Financial Shares Corporation; and **Matthew F. Souza**, Senior VP Ethics and Secretary of Irwin Financial Corporation.

The Panel reviewed recent legislative developments, including an overview of the relevant provisions contained in the Sarbanes-Oxley legislation and recent SEC rulemaking initiatives. Developments in stock exchange regulation relating to corporate governance were also examined. There was considerable discussion about the role to be played by independent directors on the board in addition to the increased role and responsibility of the audit committee. Jim Nelson discussed the concept of "director overload," referring to the increasing responsibilities of the independent director. He did emphasize, however, that banks are used to significant regulation and that new rules will simply build on an already "robust" regulatory framework. Nelson stressed the need for an "assertive, independent and informed Board."

Panel One: Matthew Souza of Irwin Financial; George Morvis of Financial Shares Corporation; James Nelson of Federal Reserve Bank of Chicago; and Jennifer Evans of Vedder Price (left to right)

George Morvis, President and CEO of Financial Shares Corporation — a Chicago-based business consulting firm — reviewed what appear to represent emerging "best practices" in the area of corporate governance. His recommendations included:

- ✓ Integrated approach to risk management
- ✓ Periodic board audits (these might be both formal and informal and be both self-administered and independently administered)
- ✓ Succession planning for board members
- ✓ Board Diversity initiatives should be in place to reflect ownership as well as community interests
- ✓ Use of Advisory Boards

Mr. Morvis also stressed that these recommendations were not simply for public institutions. Private institutions should strive to implement these best practices in order to improve the performance of their Boards and company management as well as to ensure future access to public markets should the need arise.

Matt Souza presented a most interesting case study of one financial institution's long-term efforts to address business ethics generally and to implement overriding core values that drive business strategy. He specifically addressed Irwin Financial's efforts to implement many of the best practices for corporate governance described by earlier speakers. Irwin Financial was founded in 1871 and today has more than 3,000 employees. It is a diversified financial services company with more than $3.4 billion in assets. Beginning in 1992, Irwin Financial began in earnest to articulate the company's guiding philosophy and core values. After gathering and publishing all company-wide statements about values, the management team was in a position to distill a set of core values for the organization which again were published internally and made part of all management training exercises. Indeed, an entire training series entitled "Guiding Philosophy Training" was developed and instituted. The bottom line is that, when faced with the new demands of the current legislative environment, Irwin Financial found that there was very little to be done. Its board was already comprised of a majority of independent directors (8 out of 10 directors are independent). All board committees are chaired by

George Morvis of Financial Shares Corporation (above) Jennifer Evans Vedder Price (right)

independent directors. Moreover, the company already had in place an annual planning and process improvement approach to management.

Panel Two:
Executive Compensation Under the New Rules

Thomas P. Desmond, a Partner in the firm's Executive Compensation practice; and **Thomas Haines**, a Partner at Frederic W. Cook & Co., discussed the implications for executive compensation in today's environment. This panel noted at the outset that executive pay is deemed to be excessive by a large number of stakeholders. Today, more than ever before, independent information and decision-making is required to rebut this overwhelming presumption. Both men agreed that the various components that compose a total compensation package will change. This is especially true with respect to the use and pricing of stock options. Indeed, Mr. Haines spoke at some length about the increased

likelihood of mandatory expense recognition of stock options from the SEC and FASB.

Looking forward, overall pay levels are likely to contract and there will be an increased use of cash and stock-based "full value" long-term incentives—particularly among senior executives. New disclosure guidelines will require enhanced Compensation Committee review and understanding of all management employment and compensation agreements, supplemental pensions, change in control and severance benefits.

Panel Two: Thomas Haines of Frederic W. Cook & Co. (left); Thomas P. Desmond of Vedder Price (right)

Suggested "best practices" call for financial institutions to:

- ✓ Review existing executive compensation packages in order to prepare for increased scrutiny
- ✓ Assess the effect of expensing options and / or increased footnote disclosure of option programs
- ✓ Consider the re-design of compensation programs to add elements that encourage long-term focus and long-term ownership.

Panel Three: Mergers and Acquisitions Update

This discussion was moderated by **Doug Hambleton**, a Partner in the Financial Institutions Practice Group at Vedder Price. Joining Doug were: **James M. Nuber**, Managing Director; and **William F. Hickey**, Principal of Sandler, O'Neil & Partners; and **Brad Luecke**, President and CEO of Midwest Holdings, Inc.

Panel Three: Daniel McKay II of Vedder Price; Brad Luecke, Midwest Banc Holdings, Inc.; and William Hickey and James Nuber of Sandler O'Neill & Partners (left to right)

Jim Nuber reported an uptick in bank M & A activity based on a variety of factors, including strong price performance—especially of the mid-cap banks; increased buyer confidence in the underlying franchises and the ongoing desire to increase market share; and a certain amount of pent-up demand generally. The Midwest saw 11 transactions in 2002 with an average transaction price of 180 percent of stated book value. With a view to the future, analysts at Sandler, O'Neil expect M & A activity to continue to build, but they admit that the pace of consolidation will be uneven. They expect that most activity will continue to be in the mid-cap sector, *i.e.*, sellers with assets of $2 billion and less.

There is also the expectation that divestitures of bank subsidiaries and branches should increase significantly.

Brad Luecke discussed M &A trends from the perspective of a mid-cap acquirer. His presentation was a case study of Midwest Banc Holdings, Inc. — a diversified financial services company with $1.9 billion in assets. Midwest Banc Holdings is the eighth largest publicly traded bank holding company in Illinois and, for the period 1997-2002, enjoyed average annual earnings per share growth of more than 23%. According to Mr. Luecke, an acquisition strategy is once again a viable strategic opportunity for mid-cap institutions such as Midwest Banc Holdings due to the following factors:

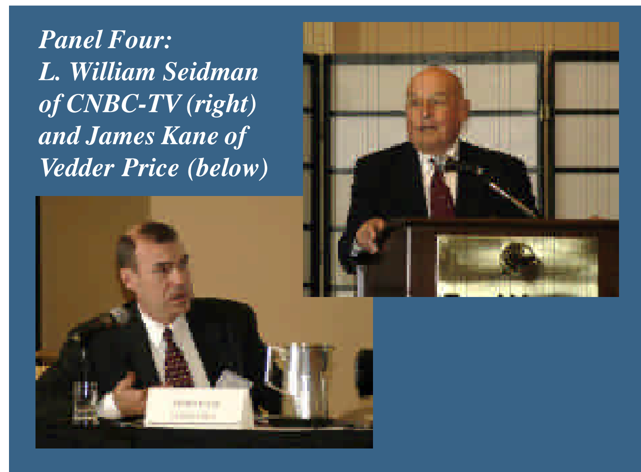
- ✓ Seller expectations are more realistic and reasonable
- ✓ Increased acquisition opportunities; he sees real opportunities for banks in the $1-5 billion in size to acquire smaller banks and further consolidate the industry
- ✓ Less "big bank" competition

What is more, Midwest Banc Holdings is able to use its own strong-performing stock to finance its growth. Key to Mr. Luecke is not to dilute the company's EPS growth and to continue to fill market and product gaps.

Daniel O'Rourke, Robert Stucker, Willam Seidman, Daniel McKay II, James Kane (left to right)

Panel Four: L. William Seidman on Banking Post-Enron

Vedder Price Partner **Jim Kane** and **L. William Seidman** of CNBC-TV teamed up for the final program of the conference. William Seidman offered a few prefatory remarks and fielded questions from the audience. Mr. Seidman remarked that banks need to guard against being caught up in the latest trend of the day. While such trends may lead to some immediate opportunities, Mr. Seidman remarked that those trends inevitably also lead to losses. The banking industry's recent experiences with the subprime market is but the latest example of a trendy market gone bad. Mr. Seidman also discussed the fundamental changes occurring on the liability side of the balance sheet and the possible need for the regulators to revisit such issues as deposit brokers and funds management practices.



Panel Four: L. William Seidman of CNBC-TV (right) and James Kane of Vedder Price (below)

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