Paul Hastings
StayCurrent
A Client Alert from Paul Hastings
February 2011

Delaware Chancery Court Confirms that Non-Signatory Shareholders are Bound to Terms of Merger Agreement

BY CARL R. SANCHEZ & LAURA MCGURTY

It is not uncommon for the equity of private companies to be held by a small group of controlling shareholders, with the remaining equity interests being held by a number of minority shareholders who are often the company's founders or management. In the context of venture capital-backed companies or private equity portfolio companies, the occurrence of such splits in equity ownership is commonplace. Despite this commonplace equity picture, interesting questions regarding the rights of the minority shareholders often arise in the context of a merger of the company approved only by the controlling shareholders. There is often uncertainty in the minds of deal counsel as to whether the minority shareholders are bound by the actions of a shareholders' representative appointed by the controlling shareholders in a merger agreement to handle disputes regarding earn-outs, other post-closing adjustments or indemnification claims. On September 20, 2010, the Delaware Court of Chancery (the "Court") issued its opinion in *Aveta Inc. v. Cavallieri*[1] (the "Opinion") which held, in part, that minority shareholders indeed are bound by such a provision contained in a merger agreement even under circumstances where such shareholders did not sign the deal documents or vote on or approve the transactions contemplated thereby[2].

In addition to providing valuable guidance in structuring merger transactions, particularly in the context of a target company with a large number of minority shareholders, the decision reflects the Court's willingness to ensure that the parties to a merger agreement receive the benefit of their bargain.

Background

In 2006, Aveta Inc., a Delaware corporation ("Aveta"), acquired Preferred Medicare Choice, Inc., a Puerto Rico corporation ("PMC"). At the time of the acquisition, PMC had two classes of shares outstanding: Class A shares which comprised 51% of PMC's issued and outstanding stock and Class B shares which comprised the remaining 49% of PMC's issued and outstanding stock. The Class A shares were held by BER Health Partners Group, Inc., a holding company ("BER"), which in turn was owned by four individuals, including Roberto L. Bengoa ("Bengoa"). The Class B shares were owned by over 100 individuals (the "Class B Shareholders"). Through a series of related corporate transactions (including a merger of PMC with a wholly-owned Puerto Rico subsidiary of Aveta), Aveta emerged from the transaction as the ultimate parent company of PMC, holding 100% of the outstanding equity of PMC through a subsidiary of Aveta. Using the Class A shares' voting power, the transaction was voted on and approved for PMC solely by the holders of the Class A shares, each of whom were also signatories to the Agreement and Plan of Merger and Stock Purchase (the "Purchase Agreement"). None of the Class B Shareholders signed the Purchase Agreement or voted on the transactions it contemplated.

The Purchase Agreement provided for a cash payment of $157 million at closing. In addition, the Purchase Agreement contemplated potential earn-out payments payable over two years based on PMC's performance, as well as potential adjustments for post-closing working capital and PMC's actual claims experience for liabilities incurred but not recorded at closing (collectively, the "Post-Closing Adjustments"). While calculation of the merger consideration was dependent on facts outside the Purchase Agreement, the mechanisms for calculating the Post-Closing Adjustments were clearly and expressly set forth in the Purchase Agreement. The Purchase Agreement also designated Bengoa as the representative of the shareholders (the "Shareholders' Representative") to "do any and all other acts or things on behalf of the . . . Shareholders . . . ," which specifically contemplated Bengoa's role in the calculation of the Post-Closing Adjustments.

Following the closing, Aveta and Bengoa, purportedly acting on behalf of all former shareholders of PMC, were unable to reach an agreement regarding the amount of the Post-Closing Adjustments. Complying with the procedures expressly set forth in the Purchase Agreement for handling a dispute between the parties, Aveta and Bengoa executed an agreement designating Ernst & Young LLP ("E&Y") to serve as the sole arbitrator, whose decision would be final and binding. Meanwhile, certain of the former Class B Shareholders separately disputed the calculation of the Post-Closing Adjustments and revoked the designation of Bengoa as the Shareholders' Representative, claiming that Bengoa had no authority to represent the former Class B Shareholders with respect to the Post-Closing Adjustments.

Issue for the Court

The primary question faced by the *Aveta* Court was whether the determinations of the shareholders representative appointed by the controlling shareholders in the Purchase Agreement in calculating the consideration payable to the PMC shareholders was binding on all PMC shareholders, including the Class B Shareholders who did not approve the transaction and did not sign the Purchase Agreement.

Choice of Law Provisions

The Purchase Agreement and the transactions contemplated thereby were governed by a combination of Delaware and Puerto Rico law. The merger itself involved two Puerto Rico corporations, and thus Puerto Rico law governed the mechanics of the merger. However, the choice of law provision in the Purchase Agreement provided that Delaware law would govern the contractual terms of the Purchase Agreement, including the designation of Bengoa as agent for purposes of making determination regarding the calculation of the amount of the post-closing adjustment.

Class B Shareholders are Bound by the Purchase Agreement

The Court held that the Class B Shareholders were bound by the terms of the Purchase Agreement and Bengoa's actions thereunder as a matter of corporate law. Section 3051(b) of the General Corporation Law of 1995 of the Commonwealth of Puerto Rico, as in effect at the time of the merger, provided that a merger agreement may contain terms that depend upon facts ascertainable outside of the agreement, as long as the manner in which those facts affect the terms of the merger agreement are clearly and expressly set forth in the agreement. Pointing out that Section 3051 mirrored Section 251 of the Delaware General Corporation Law as it existed in 1995, the Court examined the legislative history, commentary and precedent associated with Section 251 to reach the conclusion that "[t]he Post-Closing Adjustments easily qualify as provisions dependent on 'facts ascertainable outside of the merger agreement' . . ." The Court noted that while the Post-Closing Adjustments turned on financial figures from PMC's financial statements, the formulas for deriving those amounts were clearly and expressly set forth in the Purchase Agreement.

The Court's analysis of Section 251 also revealed that "facts" included "determinations and actions of a designated person or body." This definition of "facts" encompassed the appointment of Bengoa as the shareholders representative and brought Bengoa's actions with respect to the Post-Closing Adjustments and the outcome of any E&Y arbitration within the realm of Section 3051(b). Importantly, the Court noted that it did not matter whether the Purchase Agreement gave Bengoa authority to act on behalf of some, all or none of PMC's shareholders; "[a]ll that Section 3051(b) required was for Bengoa to be designated as the individual who would follow the procedures and make or participate in the determinations called for by the Purchase Agreement." Therefore, the Post-Closing Adjustment provisions, including Bengoa's appointment and actions and the E&Y arbitration, were authorized by Section 3051(b) and were binding on the Class B Shareholders.

Conclusion

The Court's decision in *Aveta* resolves lingering uncertainty as to whether the provisions of a merger agreement that are dependent on facts ascertainable outside of the agreement should be binding on minority shareholders who neither sign the agreement nor are asked to vote on the transaction. *Aveta* clearly tells us that such minority shareholders will be bound by the appointment a shareholders representative and the actions of such person in making post-closing determinations and engaging in negotiations regarding any post-closing adjustments.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

San Diego

Carl R. Sanchez
1.858.458.3030
carlsanchez@paulhastings.com

Los Angeles

Rob Carlson
1.213.683.6220
robcarlson@paulhastings.com

New York

Kevin Logue
1.212.318.6039
kevinlogue@paulhastings.com

[1] C.A. No. 5074-VCL (Del. Ch. Sept. 20, 2010).

[2] The Court in *Aveta* confronted several issues that arose out of the acquisition of PMC by Aveta. This Client Alert focuses solely on the issue of whether minority shareholders who are not signatories to a merger agreement and who do not vote on a merger are nevertheless bound by the contractual provisions of a merger agreement.

18 Offices Worldwide Paul, Hastings, Janofsky & Walker LLP www.paulhastings.com

Stay*Current* is published solely for the interests of friends and clients of Paul, Hastings, Janofsky & Walker LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2011 Paul, Hastings, Janofsky & Walker LLP.

IRS Circular 230 Disclosure: As required by U.S. Treasury Regulations governing tax practice, you are hereby advised that any written tax advice contained herein or attached was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the U.S. Internal Revenue Code.