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Be Wary of "Backdoor Standstills" in Non-Disclosure Agreements

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Don't make promises you can't keep…or that you will be unwilling to keep as evolving circumstances give rise to temptation to renege on a prior agreement. In keeping with the spirit of Delaware's "pro-contractarian public policy," the Delaware Chancery Court (the "Court") in *Martin Marietta Materials, Inc. v. Vulcan Materials Company*[1] thoroughly examined both the text and extrinsic evidence of the parties' intent at the time of execution of a set of confidentiality agreements in support of its decision to enforce the terms of the agreements to their fullest extent and enjoin one party from launching a hostile tender offer and proxy contest against the other. While the Court narrowly frames the question before it in the context of the parties' historical dealings and relies heavily on the facts before it in arriving at its holding, the message sent by the Court in *Martin Marietta* is one of widespread applicability and gives rise to practical lessons that can easily be applied to prevent future contractual remorse. In particular, transactional lawyers should make note of the Court's discussion of how precise drafting may be used to create a "backdoor standstill" in confidentiality agreements, which *Martin Marietta* illustrates can be a useful tool for a seller seeking to prevent an unsolicited offer and a trap for the unwary buyer who believes that making a hostile bid remains a viable option for getting a deal done.

Factual Background

Martin Marietta Materials, Inc. ("Martin Marietta") and Vulcan Materials Company ("Vulcan"), the two largest domestic participants in the U.S. aggregates industry, spent nearly a decade flirting with the idea of a friendly transaction, while each feared the threat of a hostile takeover by the other, before deciding to make a serious attempt at negotiating a deal. Eventually, Martin Marietta reluctantly responded to Vulcan's repeated and prolonged advances, expressing from the outset extreme concern for the confidentiality not only of the nonpublic information exchanged by the parties (the "Evaluation Material"), but even of the existence of negotiations between the parties (the "Transaction Information"). Martin Marietta's insistence on providing the utmost protection for, and limiting the scope of permitted use and disclosure of, the Evaluation Material and the Transaction Information was reflected in the drafting history of the non-disclosure agreement entered into between the parties on May 3, 2010 (the "NDA"), which was followed by the parties' entry two weeks later into a common interest, joint defense and confidentiality agreement (the "JDA" and, together with the NDA, the "Confidentiality Agreements") necessary to facilitate the examination of antitrust issues related to the potential business combination. As deal negotiations developed, so too did the dynamic between the parties. As the diligence process wore on and market factors evolved, Vulcan became less convinced of the benefits of the combination, while Martin Marietta became increasingly enthusiastic about the prospect. Despite having six months remaining on its obligations under the Confidentiality Agreements, Martin Marietta launched an unsolicited exchange offer for Vulcan's shares on December 12, 2011, followed by a proxy contest commenced on January 24, 2012.

Theories of Breach

In seeking to enjoin the unsolicited exchange offer and proxy contest, Vulcan alleged that Martin Marietta committed numerous breaches under the Confidentiality Agreements. First, Vulcan argued that Martin Marietta improperly used the Evaluation Material in formulating its hostile bid because the Confidentiality Agreements only permitted the use of the Evaluation Material in connection with the negotiation of a *friendly* transaction (i.e., one approved by the Vulcan board). Next, Vulcan claimed that Martin Marietta improperly disclosed the Evaluation Material and Transaction Information because Martin Marietta's disclosure of information in its securities filings was not "legally required" within the meaning of the NDA and Martin Marietta did not properly adhere to the notice and vetting provisions contained in the NDA. Finally, Vulcan contended that even if "legally required" was interpreted to include voluntarily-triggered disclosure pursuant to securities laws, the disclosure in Martin Marietta's securities filings went beyond what was legally required and Martin Marietta disclosed confidential information outside the context of any legal requirement in the form of push pieces to investors, communications with the media and investor conference calls.

Improper Use

The NDA expressly limits use of Evaluation Material "solely for the purpose of evaluating a Transaction," which is defined as "a possible business combination transaction [between the parties]…." Resolution of Vulcan's improper use claim turned on both the factual question of whether Martin Marietta did in fact use the information in formulating its Exchange Offer and the legal question of whether "Transaction," as defined in the NDA, included a hostile transaction. In settling the factual question, and as evidence of Martin Marietta's use of the Evaluation Material in its decision to go hostile, the Court pointed to a pile of internal Martin Marietta communications regarding "stunning" nonpublic information gleaned from a March 8, 2011 meeting with Vulcan, the resulting stark increase in Martin Marietta's synergy estimates and Martin Marietta's related willingness to shift position from the premium-receiving target to the dominant premium-offering acquiror in a merger with Vulcan.

For resolution of the legal question, the Court applied the "well-settled principles of contract interpretation" that the plain and unambiguous terms of a contract will be enforced, but if words are ambiguous, the court will look to extrinsic evidence to determine the parties' intent. The Court found both parties' interpretations of "Transaction" to be plausible and so turned to the extrinsic evidence, which ultimately tipped the scales in favor of Vulcan.

The Court first considered the parties' negotiating history and the "objective manifestations of their intent" at the time they entered into the NDA. Martin Marietta's express desire to engage only in a transaction structurally akin to a "modified merger of equals" and objection to putting itself into play to be acquired, whether by a hostile transaction or by Vulcan, supported Vulcan's assertion that a "Transaction" did not include a hostile acquisition. The Court highlighted the fact that Martin Marietta's proposed changes to the NDA had the effect of tightening the meaning of "Transaction" by adding the phrase "business combination" and replacing the term "involving" with "between," which the Court found to signal a requirement of reciprocal action. In addition, Martin Marietta's own conduct surrounding its decision to go hostile undercuts its "litigation-driven position" that the NDA permitted the use of the Evaluation Material in the context of a hostile bid. Martin Marietta attempted to seize from its management all Evaluation Material, instructed its legal and financial advisors not to use any

Evaluation material and carefully crafted its board minutes approving the consideration of an unfriendly transaction to assert that the decision was based on "publicly available information." Finally, the Court found further support in the fact that "Transaction" in the JDA was defined as "a potential transaction being discussed" by the parties. The JDA's definition, combined with both a record that reflected that the only transaction being discussed was a friendly, negotiated merger and a continuous reference throughout the JDA to "the" Transaction, suggested that only one specific type of transaction was being contemplated by the Confidentiality Agreements.

Improper Disclosure

Paragraph 3 of the NDA provides that the parties may not disclose Transaction Information "other than as legally required" and Paragraph 4 instructs that if a party is "requested or required (by oral questions, interrogatories, requests for information or documents in legal proceedings, subpoena, civil investigative demand or similar process) to disclose" any Evaluation Material or Transaction Information, it must provide notice to the other party and must limit its disclosure to what is legally required to be disclosed. The threshold issue before the Court in resolving Vulcan's improper disclosure claim was whether the parenthetical in Paragraph 4 narrowing the scope of the exception for "legally required" disclosure to those circumstances when a party had received an "external demand" also narrowed the scope of the "legally required" exception in Paragraph 3. Martin Marietta argued that the definition of "legally required" in Paragraph 3 was not qualified by the external demand requirement, and so the legal requirements imposed by securities laws to disclose certain information upon the launch of an exchange offer rendered Martin Marietta's disclosure permissible. Martin Marietta then asserted that because its disclosure was not made pursuant to an external demand, adherence to the notice and vetting provisions of Paragraph 4 was not required. Vulcan contended that the external demand parenthetical qualified the definition of "legally required" in all circumstances such that disclosure of both Evaluation Material and Transaction Material was only permitted pursuant to the receipt of an external demand for such disclosure. The Court conceded that both readings could be supported and looked to extrinsic evidence to guide its decision.

Focusing on the drafting history of the NDA in light of the business context, the Court again found that every one of Martin Marietta's proposed changes exhibited an intent to strengthen rather than weaken the protections afforded to the parties by the NDA. In particular, the Court focused on Martin Marietta's insertion of an introductory clause in Paragraph 3 that made it "[s]ubject to Paragraph (4)" as drawing "a link between Paragraph (3) and Paragraph (4) that did not previously exist," which weighed in favor of the argument that the external demand parenthetical was intended to qualify the definition of "legally required" in Paragraph 3. That this was the parties' intent was further supported by extrinsic evidence of the parties' express expectations regarding the nature of their deal negotiations. Martin Marietta, with its lingering fear of falling victim to a hostile takeover, emphasized on numerous occasions to its board, its financial advisors and Vulcan that the very existence of any negotiations must be kept strictly confidential so as to prevent "any leaks that might create unwanted activity…" and instructed its general counsel to draft the NDA with this consideration in mind. Additionally, the Court noted that Martin Marietta's proposed reading of the NDA would lead to the illogical result that a party would be subject to the notice and vetting procedures in a situation where disclosure was required by an external demand, but would be free of such restriction in those circumstances where it voluntarily took action to trigger a disclosure requirement. In light of the evidence, the Court found that the only reasonable interpretation of the NDA was one that both limited the exception for legally required disclosures to those made in response to an external demand for information and subjected all disclosures to the notice and vetting requirements. The Court's decision to apply a narrowly constructed definition of "legally required" to all disclosures of information led to the creation of a "backdoor standstill" in the NDA: Because Martin Marietta was permitted to disclose Transaction Information only in response to an external demand, and was therefore unable to comply with the disclosure requirements imposed by securities laws, it found itself in the same position as it would have been had the parties agreed to an express standstill provision in the NDA.[2]

The Court went on to determine that the subjective, slanted disclosures in Martin Marietta's securities filings went well beyond disclosing the bare legal minimum that was the contractual standard set by the NDA's notice and vetting process. Martin Marietta shrouded the process surrounding its decisions on what to disclose in privilege which, combined with evidence of Martin Marietta's employment of a public relations firm in connection with the preparation of its disclosure, led to the Court's conclusion that Martin Marietta did not stop at the legal minimum. In addition, because there was no language in the NDA to suggest that once public disclosure was made the floodgates were opened to allow disclosure outside of any legal requirement, the Court had no trouble finding that Martin Marietta's disclosures to investors and the media were in clear violation of the NDA.

Conclusion

While the Court relies on an extensive record of extrinsic evidence to support its decision to read a standstill into the NDA, its examination of relevant treatises supports the possibility of using the contractual language itself as a means of creating a "backdoor standstill" in a non-disclosure agreement, in particular by narrowing the scope of the exception for "legally required" disclosures. The guidance provided by one treatise suggests that such a standstill is created if the information that may be disclosed only pursuant to an "external demand" includes the Transaction Information that would require disclosure under Regulation M-A in the event that a party to an NDA sought to make a hostile bid, as was the case in *Martin Marietta*. Whether extrinsic evidence of intent is necessary to, or merely provides additional support for, the decision to enforce a backdoor standstill remains an open question. Regarding the implication that negative consequences may result from reading a "backdoor standstill" or other unintended provisions into negotiated agreements, the Court admonishes that the solution is not for Courts to fail to enforce agreements as written, but "for the parties who enter into them to be clear about their terms, and for a party unwilling to honor a contractual promise to not make it in the first place." The Court's holding underscores the importance of careful and precise drafting in order to make explicit the promises being made and, where desired, to allow for flexibility in anticipation of future changes in circumstances.

Practice Point

Parties in the midst of negotiating a non-disclosure agreement may wish to avoid the often-sensitive subject of a standstill provision. However, as the Court discusses in *Martin Marietta*, simple words and phrases can be woven into various provisions to create an agreement that impedes the taking of hostile action by a party in receipt of confidential information even without the inclusion of an explicit standstill.

<u>Definition of "Transaction"</u>

- When discussing the purpose of the agreement, parties can include the word "negotiated" or the phrases "mutually agreeable" or "approved by the board of directors" to make it clear that confidential information is being exchanged only for purposes of consummating a friendly business combination.

[Example]: "Each party agrees to disclose its Confidential Information solely for the purpose of discussing a *negotiated* business combination *mutually agreeable* between the parties and *approved by the board of directors of each of the parties* (a "**Transaction**")."

Permitted Use of Confidential Information

- Specifying that confidential information may not be used "in any way detrimental" to the disclosing party can serve as a signal to the recipient that it may not make a hostile bid. Placing clear limits on permitted use, in combination with a carefully crafted definition of "Transaction," can have the effect of creating a backdoor standstill.

  Example: "*Neither party will disclose any Confidential Information* of the other party to third parties *except* those Associates of such party who are required to have the information *in order to carry out the discussions of a contemplated Transaction*, nor will either party use any Confidential Information of the other party in any way *detrimental* to the disclosing party."

  Example: "Each party agrees to maintain in trust and confidence the Confidential Information disclosed to it by the other party or its Associates, and *not to use such Confidential Information* for its own use or otherwise *in any way detrimental* to the disclosing party, or for any purpose *except solely to carry out discussions concerning, and the undertaking of, a Transaction*."

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[1] C.A. No. 7102-CS (Del. Ch. May 4, 2012).

[2] A standstill provision prohibits a party from taking actions that could lead to the consummation of a business combination without the approval of the target company's board, including: (i) acquiring in excess of a certain percentage of the target company's stock; or (ii) making any proposal to the target company's stockholders, or any other public announcement or offer, to effect a business combination or a tender or exchange offer or to have its nominees elected to the target company's board.