

## MARKET CHECKS IN HOLDING COMPANY ACT TRANSACTIONS

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There is significant commentary on the fiduciary duties of directors of public companies in mergers, acquisitions, takeovers and tender offers. Although a substantial body of case law has been generated from transactions involving public companies, the sale of control triggers essentially the same fiduciary duties for directors of public companies and non-public companies alike. The board's duty to maximize the target company's value for the benefit of shareholders/members often results in the utilization of market check mechanisms. Transactions that involve the change of control of an insurance company trigger a regulatory approval process under state counterparts of the NAIC Model Insurance Holding Company System Regulatory Act (the "Holding Company Act"). This article explores the interface between market check mechanisms and the state insurance regulatory process.

### *Market Check*

*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>1</sup> was the first important judicial decision to consider the duties of directors in the context of a sale of corporate control. In *Revlon*, the Delaware Supreme Court described the fiduciary duties of directors in the following frequently quoted passage:

[W]hen Pantry Pride increased its offer...it became apparent to all that the break-up of the company was inevitable....The duty of the board has thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.<sup>2</sup>

In subsequent decisions, the Delaware courts confirmed that the *Revlon* decision stood for the duty to maximize shareholder return and that an auction process is but one of several avenues for achieving the maximization of shareholder value.<sup>3</sup> While a properly structured auction process can assist the board of directors in maximizing shareholder value, it also can be disruptive and damage valuable customer and business relationships.<sup>4</sup> In *Barkan v. Amsted Industries, Inc.*, the Delaware Supreme Court held that "there is no single blueprint that a board must follow to fulfill its duties" and that the *Revlon* decision "...does not demand that every change in control of a Delaware corporation be preceded by a heated bidding contest."<sup>5</sup>

Many sales of control are consummated outside of an auction process. In negotiating a sale with a single bidder, the board of directors of the selling company may lack the market information that would be generated through an auction process and may be forced to rely on valuation opinions. In acknowledging that the "advice [of an investment banker] is frequently a pale substitute for the dependable information that a canvas of the relevant market can provide"<sup>6</sup>, the Delaware Supreme Court in *Barkan* endorsed a "market check" mechanism to ascertain whether a higher price might be available:

When the board is considering a single offer and has no reliable grounds upon which to judge its adequacy, this concern for fairness demands a canvas of the market to determine if higher bids may be elicited....When, however, the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market....The need for adequate information is central to the enlightened evaluation of a transaction that a board must make. Nevertheless, there is no single method that a board must employ to acquire such information.<sup>7</sup>

If properly structured, a post-agreement market check process permits the board of directors of the selling company to evaluate the buyer's offer without losing it. In general, a post-agreement market check has the following elements:

First, it establishes a 'floor price' for the company in light of the fact that a signed deal exists. Second, in one form or another, it allows the seller to provide information to those who learn of the potential sale. Third, the market-check period is open for a long enough time to allow other potential bidders the opportunity to analyze the relevant data and to formulate a proposal. Fourth, the signed deal typically does not include structural impediments that would discourage a second bidder from emerging. Finally, the press release announcing the original deal must be sufficient in distribution and content to put other potential bidders on notice of the possibility of receiving information and making a bid. Although no court has required a particular form of press release, logic suggests that, at the least, the press release should not actively discourage other bidders from coming forward.<sup>8</sup>

The rigor of the market check depends upon the reliability of the information available to the board of the selling company on the adequacy of the purchase price. The market check affords the board the opportunity to fill in gaps in its valuation information by assessing whether other bidders are willing to offer a higher price. Consequently, the scope of the market check may be influenced by many factors, including the strength of the valuation analysis by the company's financial advisors, prior offers for the company and the outcome of prior negotiations over an increase in the purchase price.

In analyzing the adequacy of a market check process in relation to the exercise of the board's fiduciary duties, the Delaware courts have offered some guidance on structuring a market check. In *Roberts v. General Instrument Corp.*,<sup>9</sup> the Delaware Chancery Court held that the board of directors could reasonably conclude that a buyout represented the best available transaction based on a market check in which there was a reasonable extension of the closing date of the tender offer, a sufficient fiduciary-out exception to the no-shop clause, the ability to terminate the agreement if the company received a more favorable third party offer upon the payment of a two percent break-up fee and the issuance of a press release describing the break-up fee. In *In re Fort Howard Shareholders Litigation*,<sup>10</sup> the Delaware Chancery Court denied a motion for a preliminary injunction based, in part, on its favorable impression of the market check, which was not encumbered by protective measures and which generated eight inquiries to which the special committee responded promptly. The Delaware Chancery Court held in *In re Pennaco Energy, Inc. Shareholders Litigation*<sup>11</sup> that it was not a violation of the board's *Revlon* duties to deal with the acquiring party on an exclusive basis before it implemented a market check, but its decision was influenced by the absence of onerous deal protection measures in the transaction documents.

A market check can frustrate a buyer's objective of closing the transaction as soon as practicable. If a second bidder emerges, the initial buyer may lose its investment in the deal as well as its prospective economic advantage from the transaction. Consequently, a market check is often combined with an obligation of the selling company to pay a "break-up fee" and reimburse the buyer's expenses if a transaction with another bidder is completed.<sup>12</sup> In addition, the bidder often will seek to preclude the selling company from soliciting or entertaining other bids (a "no-shop clause") under certain circumstances. The buyer's deal protection devices may undermine the selling company's objectives with respect to the market check. The amount of the break-up fee or the scope of the no-shop clause can destroy the efficacy of the market check if it unreasonably impedes the opportunity of other bidders to offer a higher price or a superior transaction. For example, in *Phelps Dodge Corporation v. Cyprus Amax Minerals Co.*,<sup>13</sup> the Delaware Chancery Court held that an unconditional no-shop clause that restricted the selling company from entertaining other acquisition discussions was likely unenforceable because it restricted the board from fulfilling its duty to make an informed decision and the 6.3 percent break-up fee "seems to stretch the definition of range of reasonableness...probably beyond its breaking point."

To preserve judicial deference for a market check process, it is important for the board of the selling company to negotiate a "fiduciary-out provision" that permits the board to entertain unsolicited offers and negotiate a competing transaction based on the board's good faith decision that the failure to do so would violate its fiduciary duties. The

fiduciary-out provision often requires a good faith determination that the other offer or transaction is superior to the existing deal. The scope of the fiduciary-out provision is based on the negotiating leverage of the parties, subject to the recognition that greater flexibility needs to be accorded to the board of directors of the selling company where it lacks reliable evidence of value.

### *Holding Company Act*

The regulatory approval process for the acquisition of insurance companies under the Holding Company Act<sup>14</sup> provides a reasonable opportunity for the board of directors of the selling company to conduct a market check. The regulatory process affords public disclosure of the acquisition and the availability of material information on the transaction. State insurance department websites commonly provide access to the Form A application, which includes the transaction documents. The timelines for the regulatory approval process are sufficiently long so that potential bidders have a reasonable opportunity to initiate discussions, conduct due diligence and make an offer.

A successful market check process requires the availability of all information that is necessary to give other prospective purchasers a reasonable opportunity to make a topping offer. Therefore, the Form A application or the selling company's press release should disclose the contractual impediments to another offer, including the scope of a no-shop clause and fiduciary-out provision and other deal protection devices, because it lets a prospective purchaser know whether it can successfully initiate discussions with the board of directors or its representatives regarding an acquisition inquiry or offer. An important element of a market check is the disclosure of the willingness of the board of directors of the selling company to supply additional information or consider other offers. Because it is unlikely that the Form A application, which is made on behalf of the buyer, will disclose such information, the selling company's press release should specify its authority to entertain acquisition inquiries and furnish relevant information. For example, in *Fort Howard*, the press release clearly stated that the selling company and its financial advisors were authorized to receive acquisition inquiries and provide relevant information. The press release in *Roberts* was less explicit, but still disclosed the break-up fee and implied to interested persons that the selling company could respond to acquisition inquiries.

The regulatory approval process is not attuned to dealing with other acquisition offers or inquiries that may be generated by a market check. The Holding Company Act contemplates that regulatory approval or disapproval will be based strictly on the transaction submitted for regulatory review in the Form A application.<sup>15</sup> Furthermore, regulatory approval of the transaction is mandated if the statutory requisites are satisfied.<sup>16</sup> The regulatory approval process does not contemplate a beauty contest between the buyer who has submitted the Form A application and other prospective or interested offerors who may have expressed interest, whether formal or informal, in acquiring the selling company. The consideration of extraneous acquisition proposals can lead to accusations that the state insurance department has impermissibly interfered with the contractual relationship and prospective economic advantages of the selling company and the buyer. Notwithstanding this regulatory reluctance to deal with other acquisition offers, the information generated from other offers can assist a state insurance department in its review of the Form A application (e.g., by identifying the risks to the post-acquisition financial stability of the insurer or prejudice to the interests of policyholders).<sup>17</sup> Based on the regulatory benefit of reviewing such information, state insurance departments probably have the authority to mandate the disclosure of the existence and terms of other acquisition inquiries or offers.<sup>18</sup>

The regulatory approval process contemplated by the Holding Company Act should not extend to the prohibition of excessive break-up fees or unduly restrictive no-shop clauses that have the effect of impeding other acquisition inquiries or offers. The regulation of no-shop clauses, break-up fees and fiduciary-out provisions by state insurance departments would be an unwarranted intrusion into the relationship between the board of directors of the selling company and its shareholders/members. Although the relationship between the board of directors and the shareholders/members is not completely free from regulation by state insurance departments, the duties of directors and the rights of shareholders/members are largely relegated to state corporate law, which is highly developed and provides adequate legal remedies. The regulation of no-shop clauses, break-up fees and fiduciary-out provisions could essentially convert a state insurance department from a gatekeeper (which passes on the competence, integrity, financing and plans of the acquiring party) into an auctioneer. The regulation of no-shop clauses, break-up fees and fiduciary-out provisions by a state insurance department could influence a buyer to offer a reduced price or less favorable terms based on the buyer's increased risk of losing the deal.

The ultimate beneficiaries of a market check are the shareholders/members of the selling company. The *Revlon* duties of the board of directors are directed to optimizing the transaction value for the shareholders/members. The Holding Company Act provisions adopted in most states do not permit an acquisition to be disapproved on the basis of its unfairness to securityholders. The statutory framework in these states is based on (i) judicial decisions that question the authority of state insurance commissioners to protect the interests of shareholders in light of potential conflicts with the Williams Act and excessive burdens on interstate commerce, (ii) concerns that a review of the fairness to shareholders may fall outside of the scope of regulating the business of insurance and (iii) questions whether such inquiries may exceed the competence of insurance regulators.<sup>19</sup> These rationales for excluding a review of fairness to shareholders in the regulatory approval process should not be a basis for frustrating market check mechanisms implemented by the board of directors of the selling company. Market check processes can be important in many transactions that do not involve shareholders (*e.g.*, the acquisition of a mutual insurance company) or do not involve tender offers governed by the Williams Act. If the regulatory process frustrates legitimate market check mechanisms, the board of directors of a selling company may be more inclined to proceed with an auction process that can have adverse impacts on policyholders or agents or that can increase the demands on the state insurance department. Alternatively, regulatory impediments to a market check that preclude the board of directors from having a meaningful opportunity to fill in gaps in its valuation information can result in liability claims, which may have adverse solvency implications.

Those states that continue to review the fairness of the acquisition to the securityholders of the insurance company may have a more compelling interest in encouraging effective market check mechanisms in transactions that do not implicate the Williams Act or otherwise create conflicts between the state regulatory approval process and the federal securities laws.<sup>20</sup> However, a market check process that ultimately benefits the securityholders by enhancing the purchase price or transaction terms may jeopardize regulatory approval to the extent that the financial stability of the insurer is weakened or the interests of policyholders are prejudiced.<sup>21</sup>

It does not appear that the burdens associated with the regulatory approval process undercut the effectiveness of a market check. In rejecting the argument that market check processes involving insurance companies are flawed, the Delaware Chancery Court in *MONY* offered the following analysis:

Finally the Stockholders challenge the adequacy of that post-agreement market check. They argue that hostile bids in the insurance industry are rare and, therefore, that any ‘market check’ mechanism is suspect. This argument presupposes that a bid during the market check would be hostile, which is simply not true. The Stockholders confuse a friendly alternative transaction proposal with a hostile bid; the two are not the same. The Stockholders further argue that due to the complexity of the insurance industry and *MONY*, as well as [the change in control agreements], other potential bidders would have to perform extensive due diligence which could not be done in time. Market checks brought before this court typically last between one and two months. In *In re Ft. Howard Corp. Stockholders Litigation*, this court upheld a six-week market check as a proper alternative to an active auction. Surely the five-month period...is adequate time for a competing bidder to emerge and complete its due diligence, notwithstanding the complexities of the business involved.<sup>22</sup>

### ***Conclusion***

Although a market check can strain the limited resources of a state insurance department if it results in successive Form A applications or significant changes in the transaction terms or structures, it does not contravene the regulatory approval process contemplated by the Holding Company Act. The regulatory approval process under the Holding Company Act should accommodate a market check because it is a valuable tool for the board of directors to confirm that it has maximized the transaction value for the shareholders/members and because it may generate additional information that enables the state insurance department to make a more informed decision on the acquisition.

## Endnotes

<sup>1</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173 (Del 1986).

<sup>2</sup> *Id.* at 182.

<sup>3</sup> *Barkan v. Amsted Industries, Inc.*, 567 A. 2d 1279 (Del 1989).

<sup>4</sup> See *In re The MONY Group, Inc. Shareholder Litigation*, 852 A. 2d 9 (Del 2004), in which the Delaware Chancery Court held that the decision of the board of directors not to pursue a public auction process based on concerns that competitors could acquire information to attract valued career agents was reasonable.

<sup>5</sup> *Barkan* at 1286.

<sup>6</sup> *Id.* at 1287.

<sup>7</sup> *Id.*

<sup>8</sup> Gregory V. Varallo and Daniel A. Dreisbach, *Fundamentals of Corporate Governance*, 1996 A.B.A. 49. See also Evelyn Sroufe, “A Bird in the Hand or Pie in the Sky: The Market Check in the 90’s” at 12 (Insights Mergers & Acquisitions, 1991) regarding structuring a market check.

<sup>9</sup> *Roberts v. General Instrument Corp.*, 1990 WL 118356 (Del Ch).

<sup>10</sup> *In re Fort Howard Shareholders Litigation*, 1998 WL 83147 (Del Ch).

<sup>11</sup> *In re Pennaco Energy, Inc. Shareholders Litigation*, 2001 WL 115341 (Del Ch).

<sup>12</sup> Break-up fees typically vary based on the size of the transaction. See Theodore N. Mirvis, “What All Business Lawyers & Litigators Must Know About Delaware Law Developments” at 225 (PLI Takeover Law and Practice Series No. 5932, 2005), citing a Houlihan Lokey study that found median break-up fees of 3.3 percent for transaction values between \$50 million and \$250 million and 2.8 percent for transaction values over \$1 billion.

<sup>13</sup> *Phelps Dodge Corporation v. Cyprus Amax Minerals Co.*, 1999 WL 1054255 (Del Ch).

<sup>14</sup> NAIC Model Insurance Company Holding System Regulatory Act, §3.

<sup>15</sup> *Id.* at §3(B).

<sup>16</sup> *Id.* at §3(D).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at §3(B)(12).

<sup>19</sup> 1983 NAIC Insurance Proceedings I, 97-99. See *Gunter v. AGO International*, 533 F. Supp 86 (N.D. Fla 1981); *National City Lines v. LLC*, 687 F. 2d 1122 (CA 8 1982).

<sup>20</sup> Alaska Stat. §21.22.030(a)(2005); Ga. Code Ann. §33-13-3(f)(2005); Mich. Comp. Laws Ann. §500.1315(l)(West 2005); Mont. Code Ann. §33-2-1105(l)(2005); Nev. Rev. Stat. Ann. §692C.210(l)(Lexis 2005); NY Ins. Law §1506(l)(b)(McKinney 2006); Utah Code Ann. §31A-16-103(8)(a)(2005); Vt. Stat. Ann. tit. 8 §3683(f)(2005).

<sup>21</sup> NAIC Model Insurance Company Holding System Regulatory Act, §3(D).

<sup>22</sup> *In re The MONY Group, Inc. Shareholder Litigation* at 23.